The Private Eye

Spotlight on the US private D&O market

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1 The Private Eye

A spotlight on the US private D&O market

Defining private D&O

AIG and Advisen have teamed up to research and produce this ground-breaking report into the North American directors' and officers' (D&O) insurance market for private and not-for-profit companies.

Although much is known and reported on the public company sector in the US, full data and analysis on the private company and not-for-profit sectors remain elusive and – where available – incomplete.

This report will cast a spotlight on the North American private company D&O market, defining the current state of the market and exploring some of the key factors shaping the sector in the coming years. Topics covered will include:

- Market size, by premium and capacity placed
- League tables of the leading private D&O carriers in the US
- Client's viewpoint: an exclusive survey of private company risk managers
- Buying patterns: limits, rating trends
- Emerging issues: what's keeping private company directors up at night?
- Carrier's viewpoint: what does an underwriter look for in a good D&O risk? Coverage trends, pricing issues
- Claims analysis: Sources of D&O claims with case studies

This ambitious expose` will combine proprietary Advisen data and research, interviews with key market executives, a comprehensive survey of private company risk managers and claims case studies to provide the most thorough insight into the private company D&O market to date

Scope it out

Privately-held companies and not-for-profit institutions in the US can take a number of different forms;

- Private with a filed, pending, postponed, or withdrawn IPO
- Private Companies that were formerly public
- Private Companies with public debt
- Private Companies with public subsidiaries
- Venture Backed private companies
- Partnerships
- Charities
- Local government-owned entities
- HIgher education establishments
- Healthcare entities

D&O insurance policies offer liability cover for company managers to protect them from claims which may arise from the decisions and actions taken within the scope of their regular duties.

Such policies cover the personal liability of company directors and officers as individuals as well as the reimbursement of the insured company if it pays a claim on behalf of its managers in order to protect them.

In certain instances, cover can be offered for claims against the company itself. The corporate entity is often the most valuable asset of a private company when faced with bankruptcy or a very large claim that threatens the financial viability of the firm.

Cover is provided for all the directors and officers of the company and its subsidiaries; financial loss arising out of actual or alleged wrongful acts; defence costs & expenses; investigation costs; extradition costs and positions held on the board of associated companies.

Private company D&O policies are often packaged with employment practices (EPL) coverage for employment-related risks including harassment, discrimination, retaliation 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 – specific decisions with regard to management and oversight of retirement plans, and fidelity coverage, or employee theft – thereby providing broad protection for many of the types of adverse events that threaten private enterprises and their decision-makers.
Private D&O is generally offered as a package of products, with a menu of options for buyers to choose for their protection package.

The coverage options include:

- Directors and Officers Private Company Liability (individual and entity cover)
- Employment Practices Liability
- Fiduciary Liability
- Fidelity
- Employed Lawyers
- Professional Liability
- Kidnap, Ransom and Extortion

For the purposes of this report, we will focus exclusively on:

- Directors' and Officers' private and not-for-profit company liability in the North American marketplace

The report will touch on fiduciary liability, employment practices issues and other ancillary coverages where appropriate, but will focus efforts on the D&O sector in this instance.

In the same vein, although some financial institutions are privately held companies, we will not address the coverage idiosyncrasies of the financial institution in this report, merely covering the sector in general terms, where appropriate.

Financial institutions – including banks, saving and loan institutions, mortgage lenders, (re)insurance companies, credit unions and friendly societies, fund managers, investment trusts, private equity companies and stockbrokers – operate under a largely separate regulatory regime from private companies in other sectors and face different structural and operational complexities. They also tend to buy blended D&O and professional liability limits, which clouds claims analysis.

This distinct regime changes the scale and scope of the liabilities the institution is exposed to, raising a separate raft of D&O claims and coverage issues to address.

A private viewing

The risks associated with employment practices liability (EPL), professional liability and fidelity are well documented and established forms of exposure for both private and public companies alike.

However, the risks facing individual directors and officers of private companies can differ greatly from those affecting public companies.

This warrants explanation.

A common misconception about privately held companies is that they do not need to purchase management liability insurance—a misconception that can prove financially devastating to private companies and their executives in the event that they become the subject of a legal action.

According to one study from lawfirm Much Shelist, the list of third parties that could bring a claim against management of a private company is similar to that for a public company, including shareholders who are not involved with management; banks, creditors and other holders of debt; employees and labor unions; government agencies; and customers and vendors that relied on management's representations before giving favorable terms.

The number of potential litigants for a private company is far fewer as the firm has no public shareholders and stock is distributed much more narrowly. Some of the main litigants in private cases are banks, creditors, investors and minority shareholders.

Unlike the public sector, there are very few specialist plaintiff law firms focussing on privately-owned companies. Whereas the public sector has firms such as Milberg, Bernstein Litowitz Berger & Grossman and Baron & Budd, the private sector consists of a much larger number of smaller to medium-sized enterprises (SMEs), from a diverse range of industries and states, making a coherent attack inefficient for such firms.

There are always exceptions, however, including large private companies that share many traits of a public firm, while maintaining private ownership, including Cargill, Hearst Corporation and Mars.

Another difference between public and private company exposures is that the private company market is subject to less regulatory supervision and less stringent reporting requirements than public companies. By not being required to disclose details about their operations and financial outlook, private companies are not forced to disclose information that may potentially be valuable to competitors and can avoid the immediate erosion of customer and stakeholder confidence in the event of financial duress.

To date, this has resulted in fewer lawsuits and regulatory investigations, however following recent corporate scandals and the global financial crisis, this situation is changing. We will address this in the Emerging Issues section of this report.

What are the D&O insurance coverage needs of a private company?

- The company's reliance on debt financing
- Whether there is a plan for succession of management
- Whether there is a plan for succession of ownership
- The percentage of ownership in the hands of non-managers
- The quality of the relationships with investors and creditors
- The level of control and oversight senior management has over the statements and representations being made by lower-level personnel
- Whether the company is in a line of business that makes it susceptible to class-action litigation
- The merger and acquisition strategy of the company

SOURCE: Neil B. Posner, Daniel J. Struck. Much Shelist

2 Market overview
Weights and measures

We analyse metrics on the private company D&O market using Advisen data

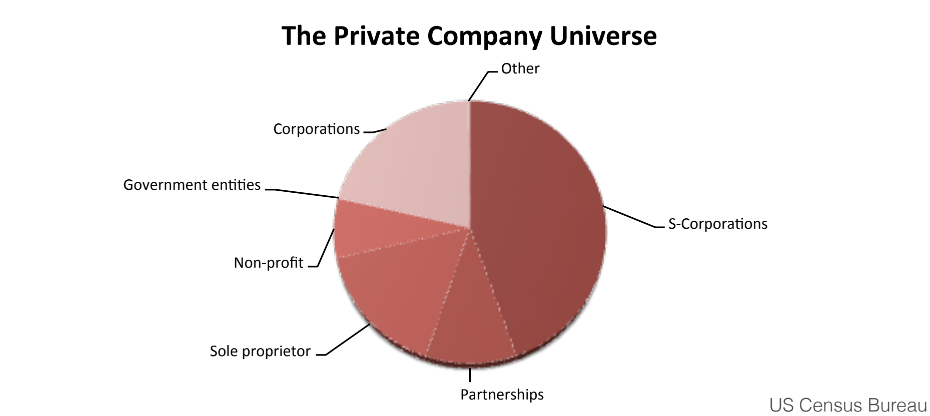
The private and not-for-profit company market is, by nature, less transparent than its public counterpart and therefore it has been historically more difficult to assess the size of the sector and its D&O insurance-buying habits.

According to US Census Bureau statistics from 2010 , there are 45 million companies registered in the US, of which 16.6 million employ less than 500 people – which provides a good proxy for private companies.

The US Census Bureau data shows 20,073,372 S-Corporations. The S corporation is used for family companies and smaller ownership groups. In most states an S corporation is owned by a limited number (25 is a common maximum) of private owners, and corporations can't hold stock in S corporations, just individuals.

The US Census Bureau records 4.7 million partnerships, 7.3 million sole proprietorships, 3.3 million non-profit entities and 11,601 Government entities.

Private corporations make up the remaining 9.5 million companies.



US Census Bureau

Advisen has been collating insurance-related data on the private company sector since its inception in 2000 and has records dating back to Its database extends to 4,000 mid-market companies, which this report uses as the proxy for private and non-profit entities for purposes of market size estimations. The mid-market estimate consists of organizations with revenues between $2.5 million and $300 million.

According to Advisen data and additional market research, overall per-occurrence limits in place in the private D&O market in 2012 totaled around $248 billion, down almost 20 percent on the $306 billion of limit placed in 2011 and down 9 percent on 2010 levels of $272 billion.

Despite a drop in limits placed in the past three years, premium written for US private company D&O business held steady at around $2.1 billion.

Year	Limit placed ($ billion)	Premium written ($ million)
2010	272	2.086
2011	306	2.16
2012	247.6	2.154

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At face value, that would suggest premium rate increases of around 15-20 percent in 2012. However, any estimate of rate levels must consider risk factors and coverage as well. Indeed, the Advisen ADVx mid-market D&O premium index, which covers more than 3,000 companies, shows premium increases of around 4 percent year-on-year to 2012. We will address pricing and coverage trends in more depth in Sections 7 and 8 of this report.

Top of the league

Advisen data captured limit and premiums written by an annual average 77 US admitted non-admitted, and foreign insurers over the period 2010-2012 and found that almost 90 percent of premium and limits written by those carriers were concentrated in the top 20 carriers. Indeed, almost 40 percent of the market premium and limit is written by the top three carriers, Chubb, AIG and alternately XL, ACE and Allied World.

	Advisen dataset ranking	2012 NAIC D&O Ranking	Top 20 US private D&O carriers by limit at risk, 2012
1	The Chubb Corporation	AIG	The Chubb Corporation
2	AIG	The Chubb Corporation	Allied Word Assurance Company Holdings
3	XL Group Plc	XL Group Plc	AIG
4	Allied Word Assurance Company Holdings	ST Paul Travelers	Nationwide Mutual Insurance Company
5	Nationwide Mutual Insurance Company	HCC	Berkshire Hathaway, Inc
6	ACE Limited	ACE Limited	ACE Limited
7	The Travelers Companies, Inc	Zurich Insurance Group Ltd	American Financial Group, Inc
8	CNA Financial Corporation	CNA Financial Corporation	The Travelers Companies, Inc
9	ICI Mutual Insurance Company	Tokio Marine Holdings, Inc	Zurich Insurance Group Ltd
10	Zurich Insurance Group Ltd	AXIS Capital Holdings Limited	CNA Financial Corporation
11	American Financial Group, Inc	American Financial Group, Inc	XL Group Plc
12	HCC Insurance Holdings, Inc	Alleghany Corporation	Tokio Marine Holdings, Inc
13	AXIS Capital Holdings Limited	W.R. Berkley Corporation	Liberty Mutual Holding Company, Inc
14	Tokio Marine Holdings, Inc	Liberty Mutual Holding Company, Inc	AXIS Capital Holdings Limited
15	Alleghany Corporation	ICI Mutual Insurance Company	HCC Insurance Holdings, Inc
16	Lloyds of London	Allied Word Assurance Company Holdings	W.R. Berkley Corporation
17	The Hartford Financial Services Group, Inc	Cincinnati Financial	Alleghany Corporation
18	Liberty Mutual Holding Company, Inc	Arch	ICI Mutual Insurance Company
19	W.R. Berkley Corporation	Old Republic	White Mountains Insurance Group, Ltd
20	Starr International Company, Inc	Nationwide Corporation	Lloyds of London

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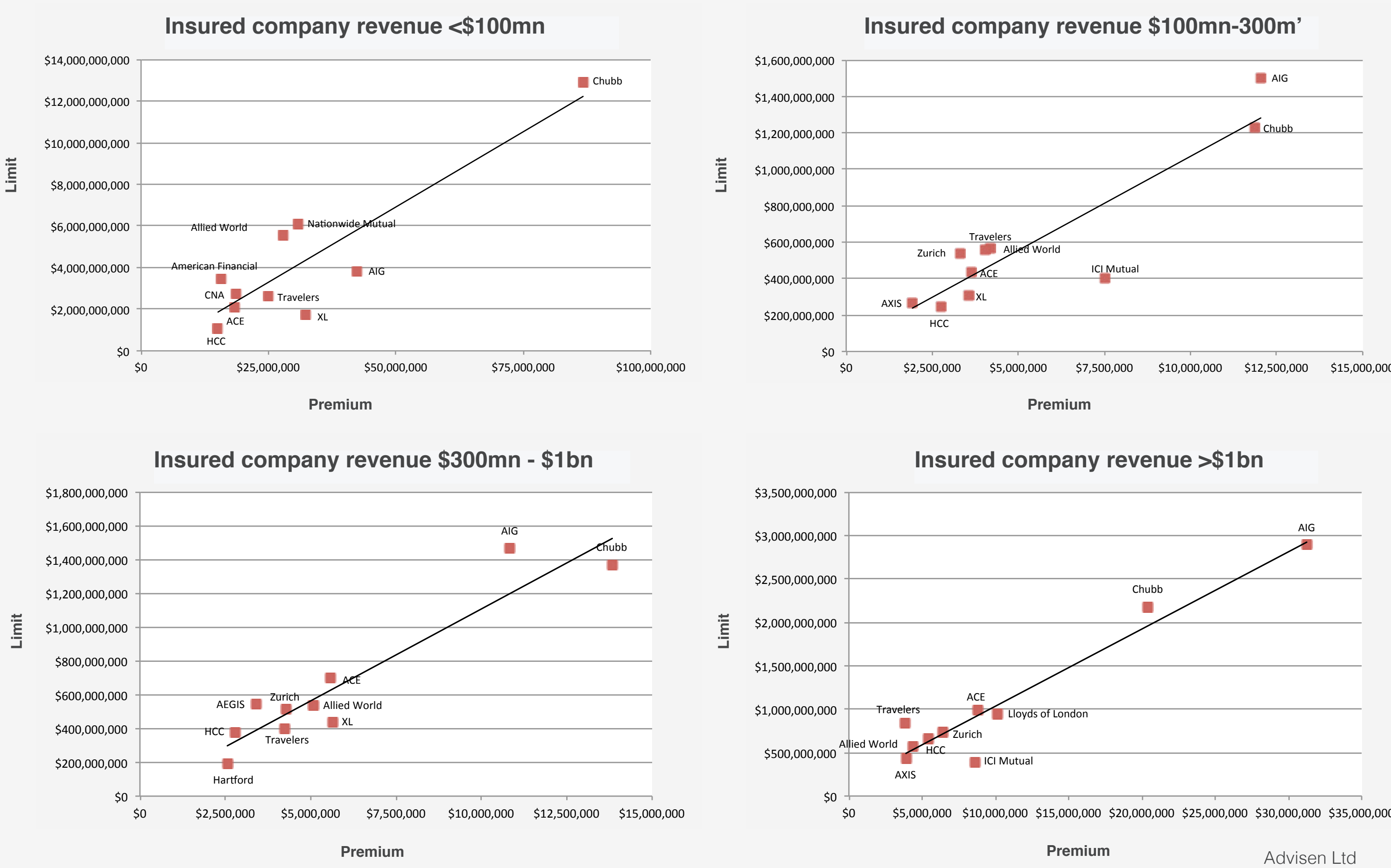
According to Advisen data, Chubb and AIG hold the top spots, writing consistently between a third and half more premium than the third-ranking carrier over the period 2010-2012.

The third-placed carrier in terms of premium in 2010 and 2012 was XL. Interestingly, the top three carriers as measured by per-occurrence limit at risk varies year-on-year.

The top two carriers measured by limit in 2012 were Chubb and Allied World, which is ranked third by premium in 2012, lies in 11th place on limit. In 2011 Chubb, AIG and Ace wrote the most limit, while the top two in 2010 were Chubb and AIG.

Carrier breakdown by client size



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The four scatter graphs shown here provide an indication of the risk appetite for the top 10 private D&O carriers over the period 2010-April 2013. The graphs, devised using Advisen data, represent the private D&O buyers by size of revenue; companies with annual revenues below $100 million; revenues between $100 million and $500 million; revenues from $500 million to $1 billion and finally companies with revenues in excess of $1 billion.

AIG and Chubb are consistently much larger players than their top-10 peers, although Chubb stands out as the largest carrier for companies with revenues less than $100 million.

Those carriers below the trend line tend to take more premium for less limit, possibly indicating a propensity to write accounts with higher risk profiles, and therefore attracting more premium. It could also reflect a focus on primary layers versus excess layer placements.

Carriers above the trend line write less premium and more limit than the mean. This could indicate an appetite for excess layers, less risky accounts or a competitive pricing strategy.

Room to grow

Despite a maturing market that has been offering a range of D&O products to private and non-profit companies for more than a decade, there is enormous room for potential growth in the sector.

Advisen data shows an overall 30 percent market penetration for D&O insurance purchase among private, non-profit and government entities.

D&O market penetration - private/non-profit companies

Revenue range ($)	% purchasing D&O
0<500K	33.4%
500K<1M	21.0%
1M<2.5M	18.8%
2.5M<5M	20.5%
5M<10M	26.3%
10M<25M	32.9%
25M<100M	40.4%
100M<300M	48.2%
300M<1B	58.0%
1B<5B	67.5%
5B+	66.7%
Total	**30.8%**

Source: Advisen 2011

Penetration levels vary according to the size of the company. Only 28 percent of firms with revenues below $100mn per year currently buy D&O insurance. This compares to an average of 60 percent of firms with revenues above $100mn that buy the coverage.

These statistics would suggest that there is enormous growth potential in the private/not-for-profit D&O market. However there are particular hurdles to overcome, including price-sensitivity and a perceived lack of litigation risk. These concerns are highlighted in our risk manager survey in Section 4 of this report.

So, which private and non-profit companies should be buying D&O insurance cover? Taking current Advisen data only – which shows 30 percent market penetration – the potential market size is around $6-7 billion.

However, as with all data this sample is incomplete. For the purposes of this report, we assume that all companies with annual revenues exceeding $1 million should buy at least $1 million of cover and that all non-profit organizations–regardless of size – should buy.

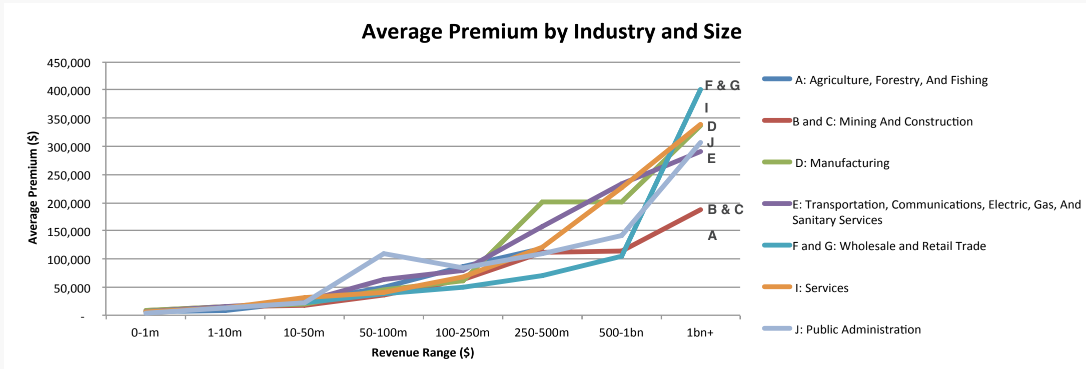
This results in a potential market size for US private and non-profit company D&O insurance more than $20bn.

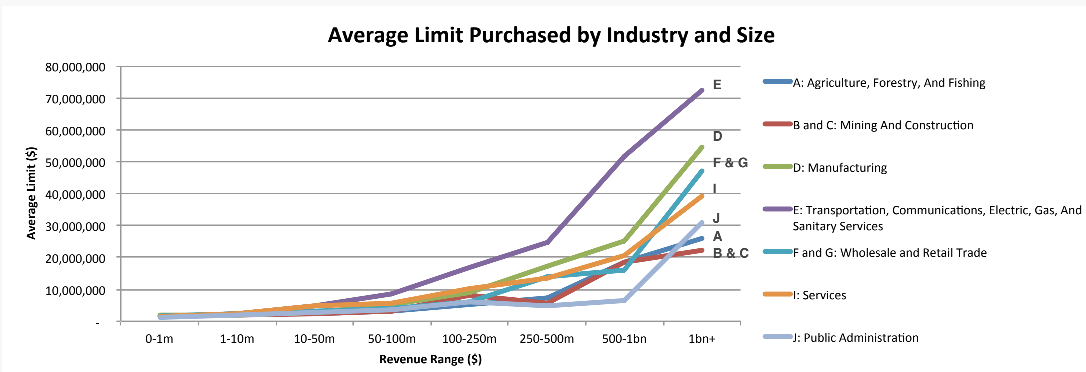
3 Buying patterns

Break it down…

Having established the overall market size and the main players in the US private and non-profit D&O market, in this section we will scrutinize the buying patterns of the D&O insurance buying universe.

As seen by these first two graphs, the average premium paid and the average limit purchased by private companies is consistently low for all smaller companies, irrespective of industry sector. The data pertains to the past ten years (2003-April 2013).





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The average premium paid by private companies with annual revenue up to $50 million is $15,851 for an average policy limit of $2.6 million.

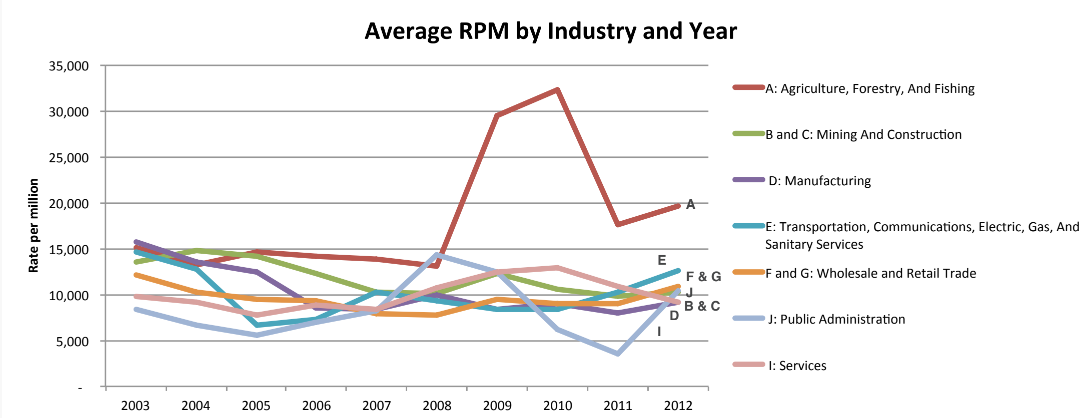
Only once revenue exceeds $50 million per year does an industry-level divergence in premium paid and limit purchased become apparent.

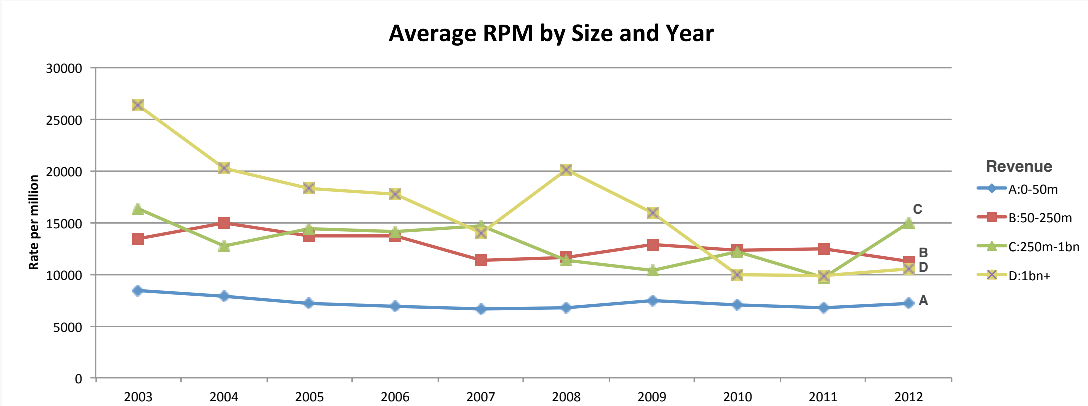
Accounts with $50 - $100 million of revenue pay on average $50,000 for their program, buying average limits of around $5 million. Premium and limit averages continue to diverge by industry sector as the revenue size of the company increases.

Industries that tend to pay more premium and buy more limit are the manufacturing, transportation, communications, utilities and the general service sectors.

Levels of premium paid and limits purchased have remained fairly static over the past ten years, with larger accounts showing a small decrease in average premium over time while mid-sized companies showed a tendency to change the average limit purchased over time.

The most useful metric for analyzing these buying patterns, however, is the average rate per million (RPM) paid by private companies, which provides an indicator for the carrier competitive market cycle and also risk exposure changes in private companies.





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For smallest accounts, there is little industry-sector differentiation. However, on accounts with revenues in excess of $250 million, carriers appear to rate similar-sized accounts differently, according to the business they're involved with. Mining and construction rises to the top, paying the highest RPM. It remains the highest-rated industry sector until private company average annual revenues exceed $1 billion. For companies with revenues in excess of $1 billion, public administration entities pay the highest RPM.

The services sector, retail and wholesale trade sectors and companies involved in manufacturing also begin to pay more than other industries when annual revenues rise above $250 million, according to Advisen data.

Over time, the RPM paid by private and non-profit companies of all sizes has trended downward.

The biggest decline since 2003 has been for accounts with revenues over $1 billion. Average RPM in 2012 was just over $10,000, versus a rate of $25,000 per million of cover purchased in 2003.

The greatest rating volatility was seen in companies with annual revenues of $250 million – $1 billion. Having sharply declined from $16,000 RPM in 2003 to $10,000 in 2009, this size of company has seen increased rates over the past two years.

At just under $15,000 RPM in 2012, the average RPM for companies in the $250 million – $1 billion revenue range is just 10 percent less than it was in 2003.

4 The client's perspective

From the horse's mouth...

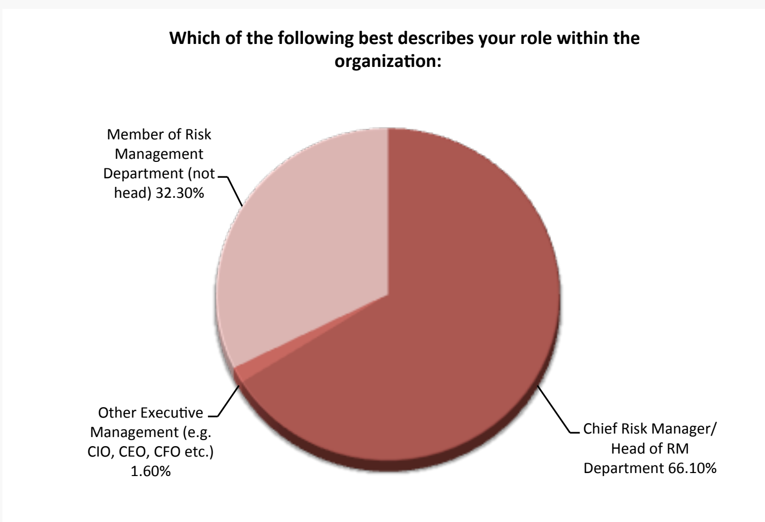
A buyer survey of 260+ US private company executives highlights a strong demand for D&O insurance amid shifting market dynamics.

Advisen tapped its strong contacts in the risk manager database to solicit private company executives' views on the factors shaping D&O purchasing decisions and emerging issues on the top of boardroom agendas.

With 268 respondents to the survey, it also provides a unique insight into the make-up of this corporate segment, providing a detailed picture of who the buyers are, what businesses they're in and what D&O cover they buy.

Building a picture

66 percent of respondents were chief risk officer or head of the risk management department, with 32 percent performing a senior role within a risk management function. It is interesting to note that in private companies – which tend to carry smaller staff numbers than public companies – the role of risk manager is often shared with other duties, including head of human resources, general counsel or financial officer.



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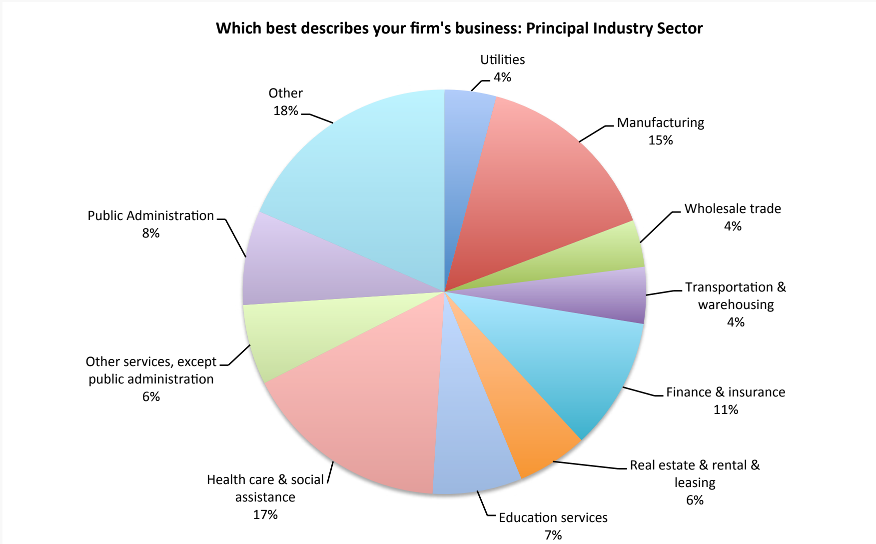
The respondents were geographically diverse, representing businesses headquartered in the majority of the US States.



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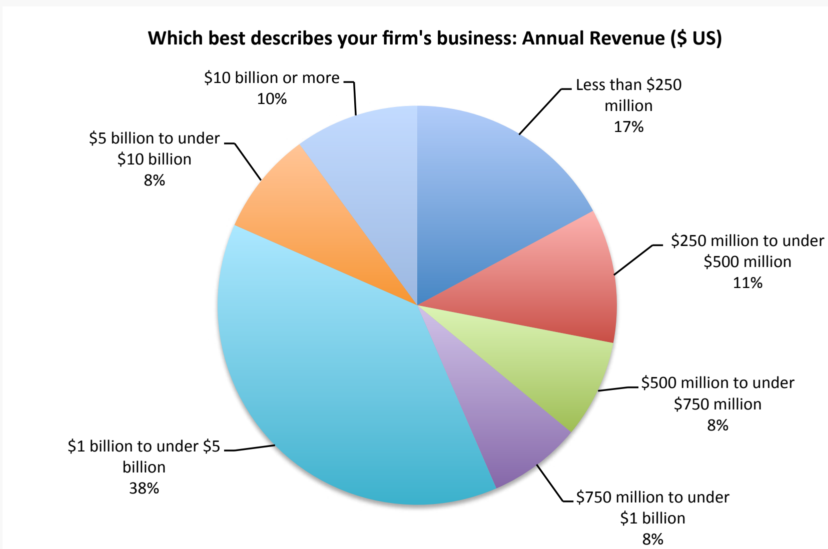
The top five industries represented by the respondents were healthcare, manufacturing, finance and insurance, public administration and education. Closely followed by real estate, transportation and warehousing and utilities companies.

Revenue-wise, 38 percent had revenue of $1 billion - $5 billion, with 56 percent of total respondents earning more than $1bn annually. 28 percent of companies represented earned less than $500mn each year.



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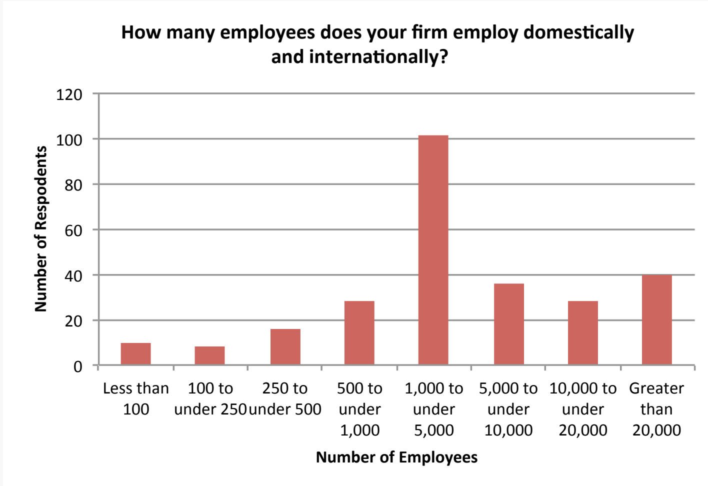
It should be noted that this sample represents the larger private companies. Advisen data shows an overall 30 percent market penetration for D&O insurance purchase among private, non-profit and government entities (see Market Overview Section).



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77 percent of firms employ more than 1,000 staff, leaving 23 percent employing less than 1,000 people. The largest segment (38 percent) fell into the 1,000 to 5,000 employee range.

Buying dynamics

Just over 90 percent of private companies surveyed already buy D&O insurance, with around a third buying less than $10 million in limit (see page 15).

19 percent bought $1-5 million of cover with 11 percent buying $6-10 million, while at the other end of the scale, 16 percent bought D&O limits in excess of $96 million (see page 15).

In all, 72 percent of respondents bought less than $50 million of D&O insurance cover.

Once again, the survey sample represents the larger private companies in the sector. For example, Advisen benchmark data shows of companies with less than $250 million in revenue, more than half buy $1 million or less in limit. Pricing on the limits purchased by survey respondents was within the lower bounds of our ranges, with 37 percent paying $1,000-5,000 per million of cover. Meanwhile, a further 28 percent paid $5,001-7,500 per million. We completed a further analysis of private company buying patterns in Section of this report.

In two-thirds of cases, the limit purchased had not been increased or decreased in the previous three years. However, comments from private company executives highlighted some of the reasons those 36 percent of respondents did increase cover.

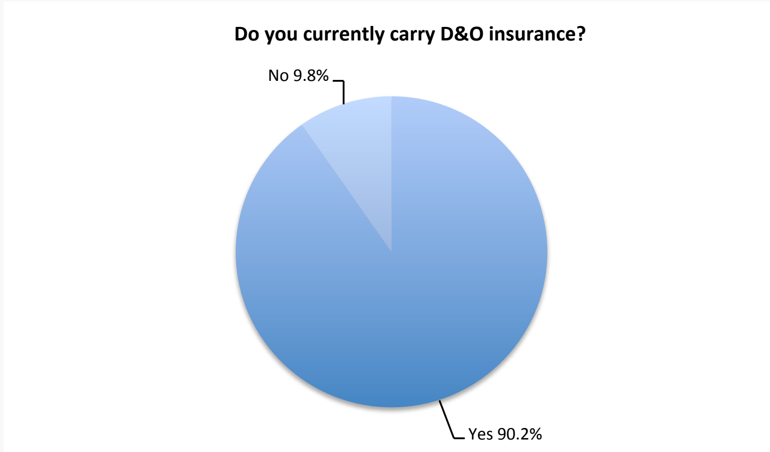
The main reason for increasing limits was to buy a separate tower of A-side D&O cover

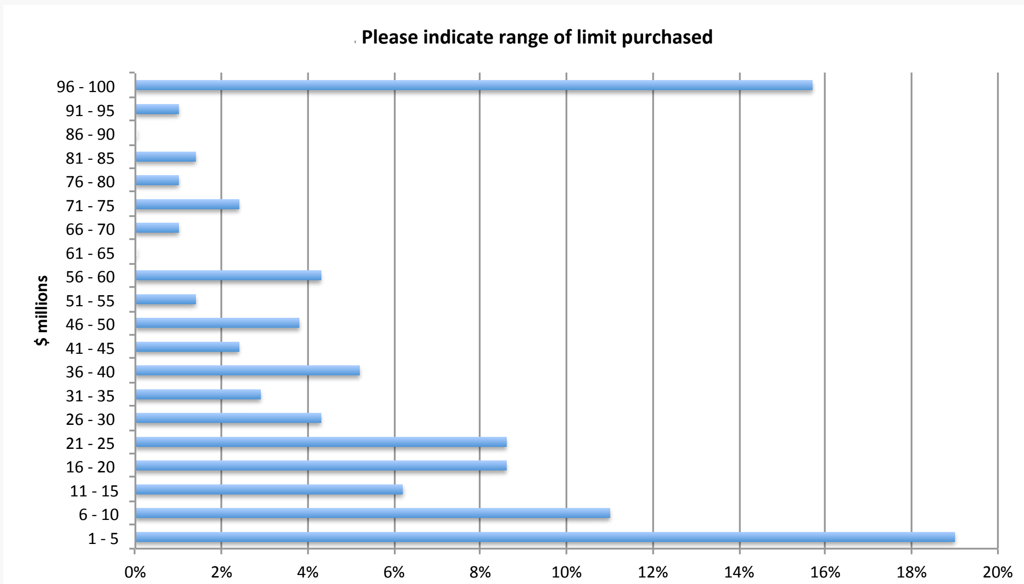
which covers the individual directors and officers liabilities in the event the company is unable or unwilling to indemnify them for settlements and defense costs.

This uptick in A-side D&O purchase is further evidence of the product's heightened importance. Directors and officers feel the need for additional assurances beyond corporate indemnification.

Other reasons for amending D&O coverage limits included the Board's concern about the financial impact of potential claims and a heightened awareness of an increased risk environment, gleaned from regulatory changes and claims brought against competitor companies.

Many D&O buyers also carry out regular benchmarking exercises against peers and base decisions on limits on comparable competitors or as a result of growth or acquisition within their own firm.


Do you currently carry D&O insurance?
No 9.8%
Yes 90.2%


Please indicate range of limit purchased
$ millions
96 - 100
91 - 95
86 - 90
81 - 85
76 - 80
71 - 75
66 - 70
61 - 65
56 - 60
51 - 55
46 - 50
41 - 45
36 - 40
31 - 35
26 - 30
21 - 25
16 - 20
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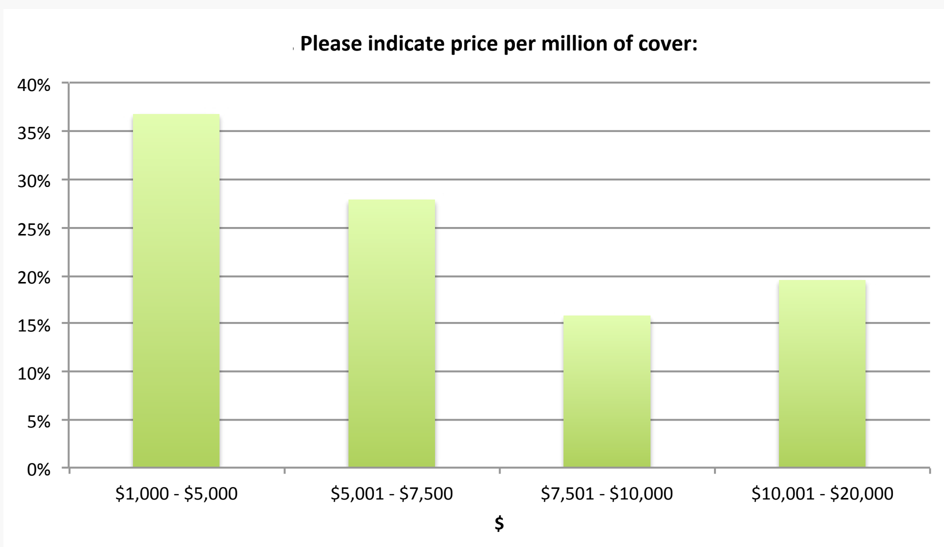
14%
16%
18%
20%


Please indicate price per million of cover:
40%
35%
30%
25%
20%
15%
10%
5%
0%
$1,000 - $5,000
$5,001 - $7,500
$7,501 - $10,000
$10,001 - $20,000
$

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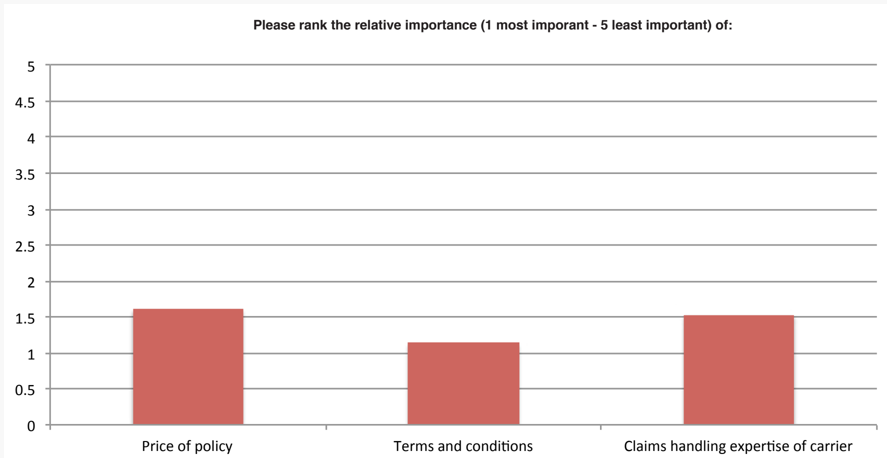
There wasn't a lot to call between the three determining criteria for the D&O purchase decision, but favourable terms and conditions of the policy came out marginally ahead, with 35 percent ranking it the most important feature. 32 percent each ranked price and claims handling ability as one of the most important criteria.

The majority of companies received only one claim during the three-year period, while some noted receiving around 6 claims and one "a dozen or so"

This is surprising, given the increase in litigation in the US, which we will cover in Section 9 of this report.



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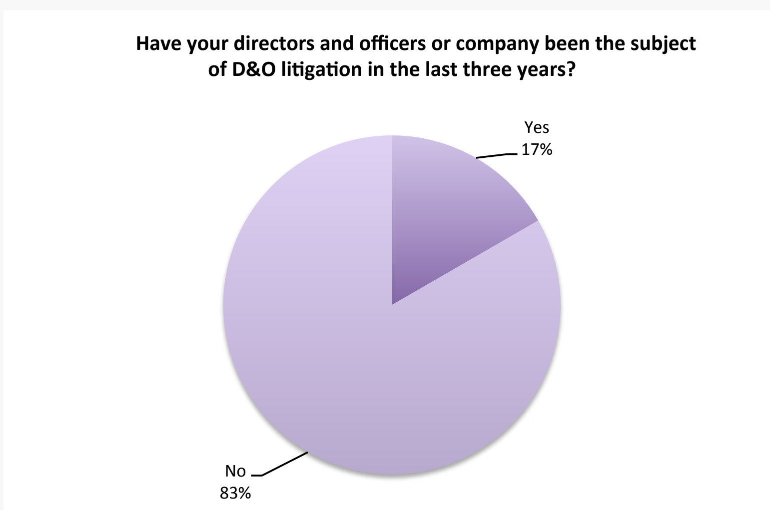
The shop window

As any buyer or seller of insurance will know, how the policy responds in a claim situation is paramount, and the service provided during this process represents the 'shop window' for the cover.

Interestingly, only 17 percent of our survey respondents had been subject to a D&O claim in the previous three years, which underlines the previous comments that almost half of the companies that did not buy as they considered litigation to be an insufficient threat to warrant the purchase.



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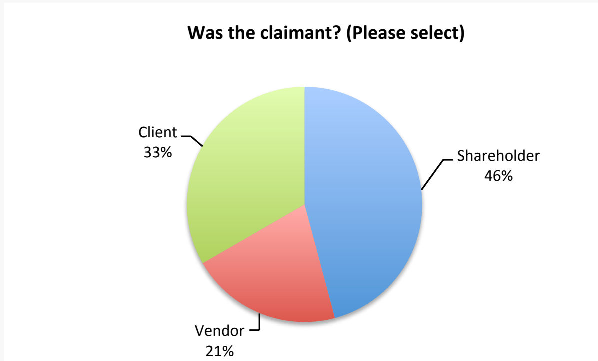
Of those that did suffer a claim, 46 percent were shareholder lawsuits, which indicates an interesting trend for private companies, which we shall discuss in greater depth in Section 9 of this report. Client led lawsuits (33 percent) and vendor lawsuits (21 percent) made up the remainder of the litigants in the claims suffered by our private company universe.

Other categories included former employees claiming under the EPL section of the policy, which is not within the scope of this report.



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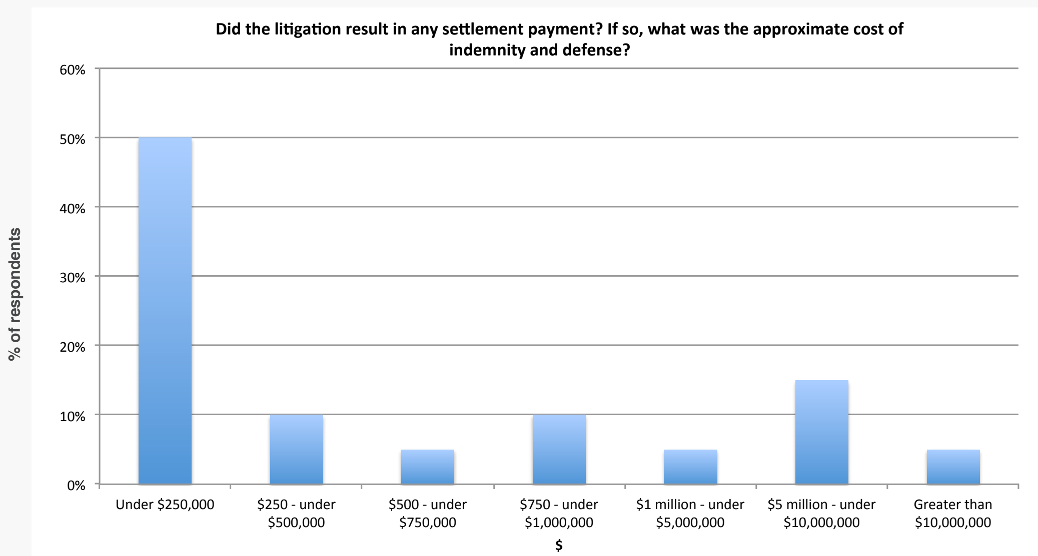
50 percent of the claims that resulted in a settlement fell under $250,000, with only 25 percent settling for greater than $1 million.



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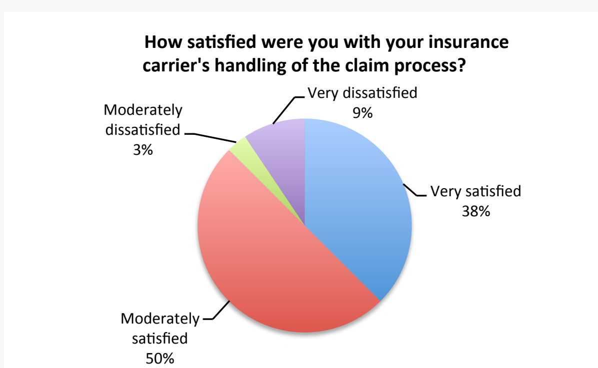
When dealing with their insurance carriers and intermediaries, 87.5 percent stated that they were “very satisfied” or “moderately satisfied” with the service that they received. Only 9 percent were “very dissatisfied.



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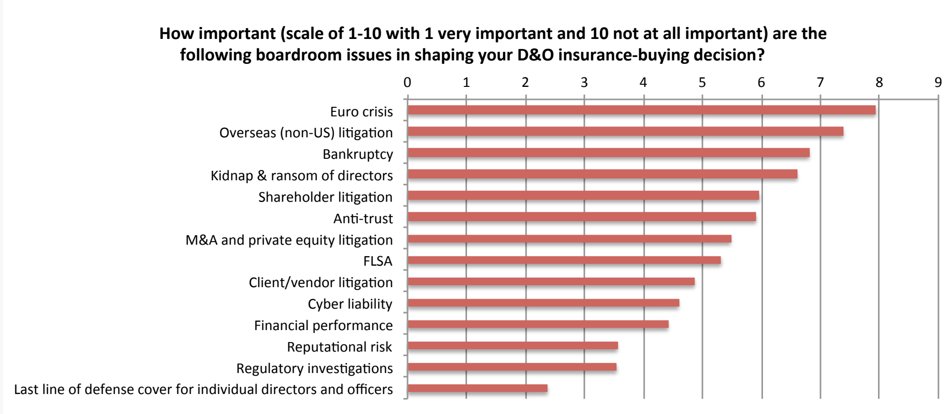

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The boardroom agenda

Finally, the topics that topped the list of boardroom concerns did not closely match the types of claims that private companies have been suffering in the past three years, as outlined above.

Indeed, they highlight some emerging concerns for private company owners and managers, which we will discuss in Section 6 of this report.

Not surprisingly, having coverage as a last line of defence for individual directors and officers of the company was ranked highest among boardroom concerns, with other classic private company litigation concerns including client/vendor litigation, shareholder litigation and anti-trust suits making their way into the top 10.

However, new issues emerging on the agenda included regulatory investigations and reputational risk –which ranked equal second – cyber liability, M&A and private equity litigation and the Fair Labor Standards Act.

5 The Carrier View

What makes a good private D&O risk?

Both the characteristics of a private company and the D&O insurance coverage available to private companies can vary widely from the public company sector.

These differences necessitate a distinct underwriting approach to the public company sector.

Advisen asked Phil Rhodes, senior vice president, financial lines, at AIG to outline what he looks for a in a good private D&O risk…

He highlighted four key points:

- A professional and long-standing management team. Also an agreed management succession plan is important in a private company

- Ownership largely comprised of insiders and professional investors

- Strong financials which demonstrate growth, positive cash flow, manageable debt, net income, retained earnings and positive working capital

- A good story: Looking for insureds that are willing to discuss their company, their corporate culture, and have a compelling business plan. Underwriters will undertake financial and Industry analysis, while looking at corporate policies, procedures and loss history. Does the company operate in a heavily regulated industry? Is the Company expecting any M&A activity?

6 Emerging exposures

Evolving threats

As the economic and regulatory landscapes continue to shift under business-owners' feet, directors and officers are facing an ever-changing vista of legal exposures. Here we discuss some pertinent new issues…

Regulatory uptick

A number of corporate scandals in the early years of this millennium – including Enron, Worldcom, and IPO laddering – and the recent financial crisis have resulted in heightened scrutiny on the entire US business sector.

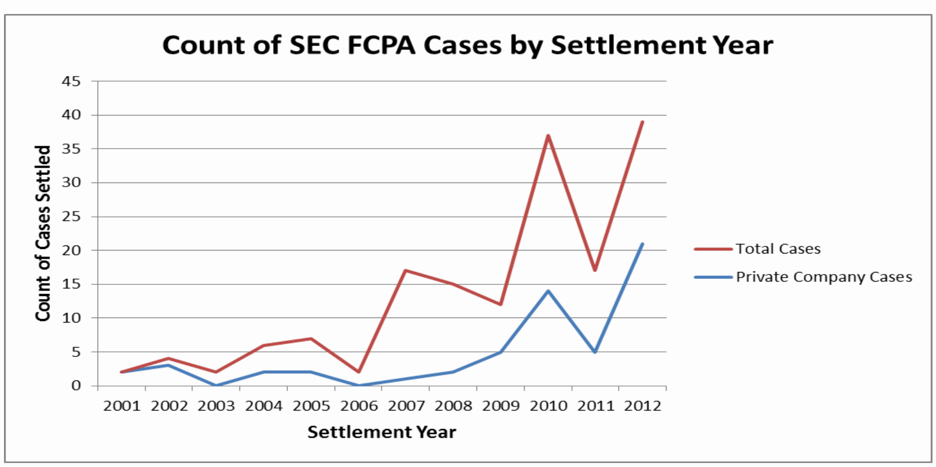
While the root cause of the problems in the last decade can mainly be laid at the door of financial institutions or large, listed corporations, the regulatory aftermath has spread more widely, affecting how private and not-for-profit companies are regarded as well.

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.

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.

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 (FCPA) and the Fair Claims Act, both of which have significant implications for private company directors and officers.

Advisen data shows a steep uptick in the number of Whistelblower and FCPA cases for both public and private companies since 2009. Although private company cases remain well below their public sector cousins (around half the number in the case of FCPA), the trend is one which could result in a rise of claims.



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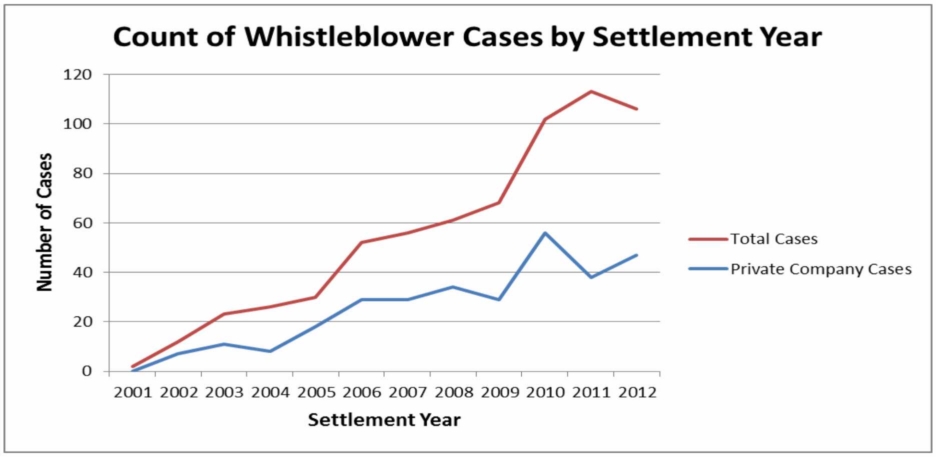

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On the employment practices front, the Fair Labor Standards Act (FLSA) – also known as the Wages and Hours Bill – is another hurdle for private companies to jump and is the source of a growing number of claims.

Investigations and fines and penalties are not generally covered under a D&O policy, as they fail to meet the definition of claim – which is triggered when there is a written demand for money. Cover may be triggered if the investigating party brings a claim, but it is more likely that another interested party – for example a shareholder – will sue when an investigation occurs.

Some insurers are responding to these increased threats, with the launch of specific products offering reimbursement for the defense of regulatory investigations.

JOBS fallout?

The federal Jumpstart Our Business Startups (JOBS) Act, which was signed into law in April 2012, is designed to help smaller and new companies raise capital, to boost the smaller business sector post-recession.

The JOBS Act expedites those aims in five main initiatives, according to Andrea Cortland at Cozen O'Connor :

- Relaxes or entirely removes restrictions on private fundraising, including limitations concerning how and to whom private companies may market their Rule 144A securities offerings
- Raises the limit for securities offerings exempted under Rule 505 of Regulation D from $5 million to $50 million, thereby allowing for larger fundraising efforts
- Broadly permits the previously limited allowance for "crowd funding," that is, the use of online platforms to raise up to $1 million in capital from numerous small investors over a 12-month period
- Grants Emerging Growth Companies (EGC) – companies with annual revenues less than $1 billion – greater flexibility to test the waters with the Securities and Exchange Committee and potential investors ahead of an initial public offering, before they make their finances and other internal information available to the general public
- Relieves EGCs from some of the more burdensome obligations imposed by Section 404 of the Sarbanes-Oxley Act and related rules and regulations

While intending to relax fundraising rules to stimulate growth, the Act may bear unintended legal consequences for private companies, which may be subject to lawsuits alleging misrepresentations in offering documents, or broader regulation via this new limited SEC disclosure and broadened publicity approach.

The right medicine?

Companies in the healthcare sector also should be aware of potential D&O exposures resulting from the 2010 implementation of the Patient Protection and Affordable Care Act (PPACA), 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.

The PPACA encourages economies of scale and, consequently, has spurred health insurers, hospitals, doctors' groups and other healthcare organizations to merge.

Anti-trust violations are a common cause of complaint against healthcare organizations and this recent merger activity opens the door for increased anti-trust litigation alleging that a healthcare operator is unfairly monopolizing its market. Antitrust claims have the potential to be very large and can threaten a healthcare organization's very existence, according to US broker AmWINS . The penalties for violating antitrust laws vary according to the specific law(s) involved, but they can include fines of up to $10 million per violation and, in some cases, civil penalties of up to three times the actual compensatory damages.

Cyber oversight

According to Verizon's 2013 Data Breach Investigations Report , there were 47,000 reported security incidents and 621 confirmed data breaches involving around 44 million compromised records in 2012. And 38 percent of those were perpetrated against smaller businesses – defined as those employing fewer than 1,000 people.

The theft of credit card information, patient records, personal data and individual states imposing different criteria for breach reporting, result in a complicated and costly process.

The liability risks arising out of cyber threats are not the domain of this report, as separate insurance products are available to cover errors & omissions, defense costs and reimbursement of defense costs (among others) in the event of a cyber attack.

However, there is risk that the Board of Directors' decision not to buy cyber liability insurance could result in shareholder claims against a private company's D&O policy.

Guidance from the Securities Exchange Commission (SEC) also strongly suggests disclosure of material cyber vulnerabilities and claims . While only "guidance" applicable to SEC filers, it will inevitably trickle down to the private company segment as it becomes deemed best-practice for the industry as a whole. Examples of data breaches are numerous and frequent, but the unifying thread for smaller and private companies is that they can be extremely costly – both financially and for a firm's reputation.

At an average cost of $194 per compromised record , even a comparatively small business could conceivably run up a tab in the hundreds of thousands, or even millions of dollars, as a consequence of a data breach.

In some smaller companies, this may result in the D&O insurance policy being the largest asset that the entity owns and could come under attack for payment.

It is possible that shareholders could sue the directors and officers for breach of fiduciary responsibility, as cyber liability insurance was available and the decision not to buy caused the company financial loss.

Slip of the tongue

As our survey in Section 4 showed, reputational risk ranked equal second alongside regulatory investigations as the most important boardroom issue concerning directors' and officers' liability.

The employment practices liability implications of employees posting inappropriate or inaccurate messages on social media sites such as Twitter, Facebook or YouTube are widely understood. They also fall outside of the scope of this report, as discussed.

Damage to brand and reputation can occur for many reasons – a financial scandal, a badly-managed product recall, worker safety issues – but an increasing source of concern is employee activity in social media.

In North Carolina in 2009, two Domino's Pizza employees filmed a kitchen prank on their mobile phones and posted the video on YouTube.

Within hours, the video had been viewed more than a million times on YouTube. References to it were in five of the 12 results on the first page of Google search for "Dominos," and discussions about Domino's had spread throughout Twitter. The firm was facing a reputational crisis which was spiraling out of its control via social media networks.

Domino's experiences are cautionary tales for private company executives, who fear action by an employee on social media sites could cause major reputational and financial damage to their business.

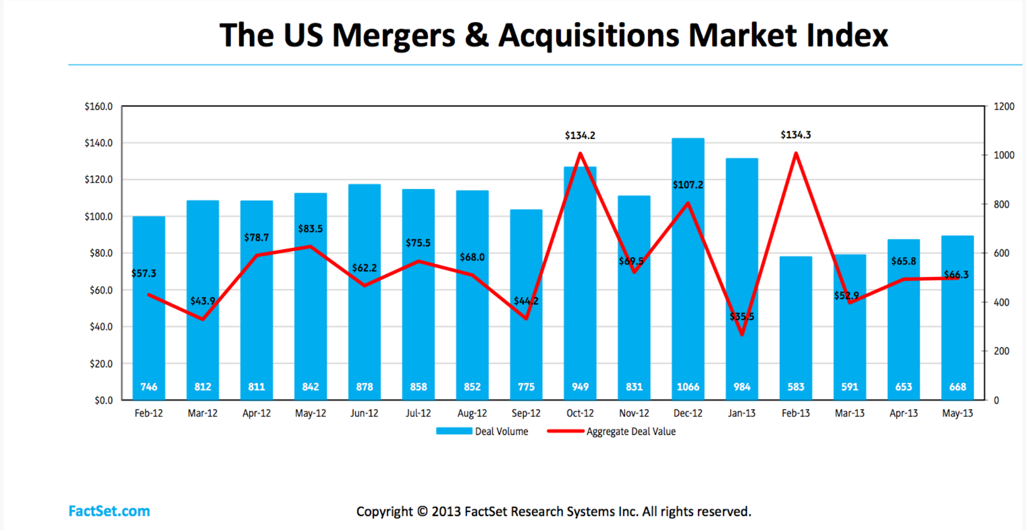
Some private D&O insurance policies offer access to a Crisis Fund, which is available to hire a public relations firm as preventative medicine for reputation-threatening events.

Another phenomenon which is causing consternation among private company board members is the rising number of company executives and indeed, companies themselves, which have accounts on such sites in their own right. An inappropriate or untimely disclosure by an executive or under a corporate account could have damaging consequences for a firms' reputation and financial viability – leaving it open to lawsuits from disgruntled investors or other stakeholders and even unwanted attention from regulators such as the FTC or even the SEC.

Buyer beware

As the green shoots of growth start to emerge in the US economy following the Great Recession, so merger and acquisition (M&A) activity is also gaining pace.

According to a May 2013 report from FactSet , US M&A deal activity went up in April 2013, increasing by 7.9 percent with 625 announcements compared to 579 in March. Aggregate M&A spending increased as well. This April 10.3 percent more was spent on deals compared to March.



Private companies face liability exposures, whether they are the acquirer or acquiree in an M&A deal. It is common for minority shareholders to sue following M&A, disputing the deal valuation, disagreeing on the corporate strategy the Directors or majority shareholders have embarked on, querying due diligence work, etc.

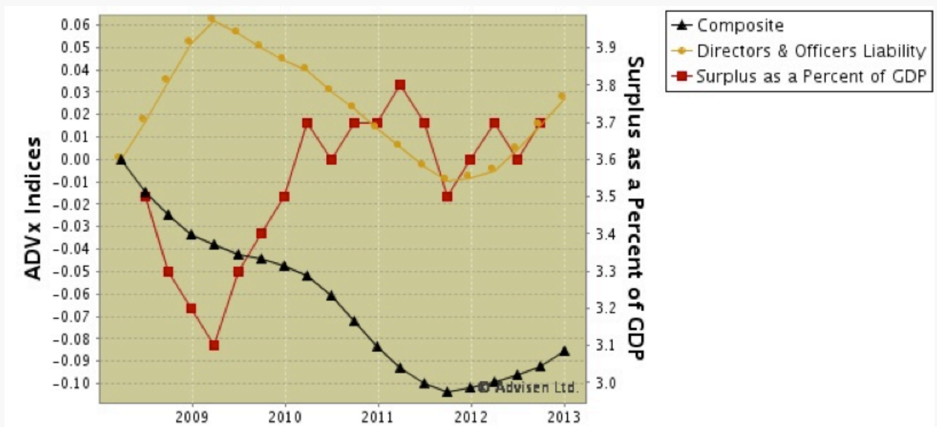
In addition, many private equity companies are pressured to deploy the cash they have accumulated following successful recent fund raises or divestments. There is a risk that lawsuits could follow a less-successful investment. Shareholders may allege inadequate due diligence or a lack of fairness opinions, among other fiduciary oversights..

7 Pricing trends

Into a hard market?

Private company D&O rates are increasing across the board, with Advisen data showing a consistent increase in renewal premiums and rate per million (RPM) on private company and mid-market accounts in the past 18 months.

According to Advisen's ADVx Mid-market Account Indices – which track the percent change in renewal premiums on Mid-market Accounts, with total annual premiums below $250,000 – D&O pricing has been on the rise since in Q3 2011. The ADVx includes renewals with existing carriers, as well as business that changes carriers, often at lower rates.



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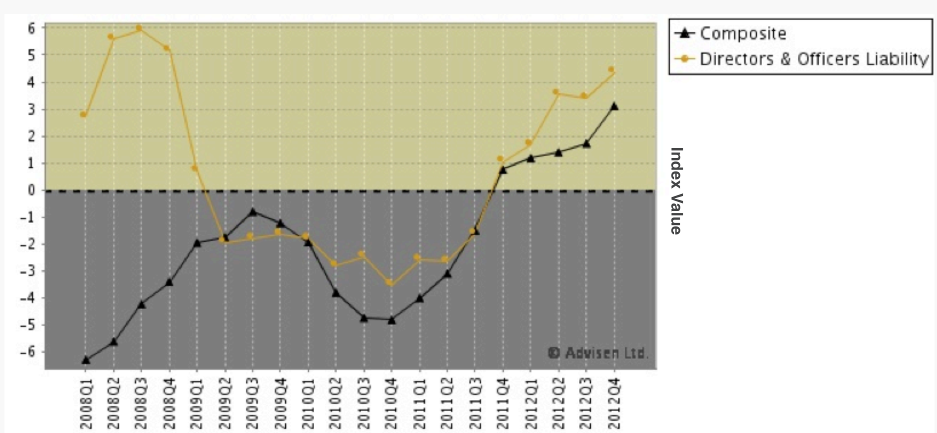
The mid-market index shows renewal pricing recovering by 4 index points over the period since Q3. In late 2011, pricing was below 2008 levels, when the mid-market index was set at zero. In the graph shown, we track the mid-market D&O renewals against the composite mid-market insurance renewal premium. Both bottomed-out in 2011, with D&O showing a slightly steeper recovery since that time.

Shown as a percentage change of renewal premium quarter-over-quarter, the recovery looks to have started as early as Q4 2010, halting a downward trend which started in Q4 2008. The percentage change index on renewal rates for mid-market accounts recovered from -0.3 in Q4 2011 to +0.45 in Q4 2012 (see graph).

This recovery largely tracks the composite mid-market renewal pricing index.



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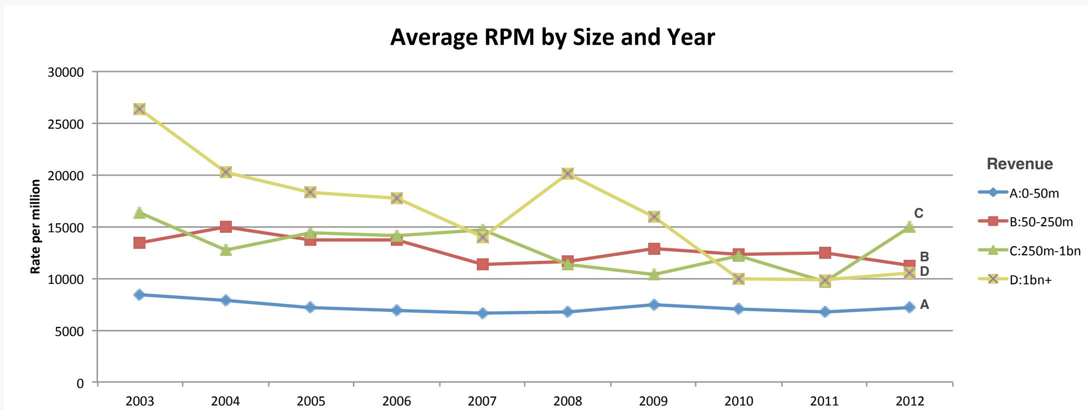
This data is supported by findings from a recent Towers Watson survey which states that 41 percent of private/not-for-profit respondents reported an increase to their primary policy premium in 2012, versus just 18 percent receiving an increase in the previous year.

As indicated previously, in the Buying Patterns section of this report, the rate per million (RPM) paid by private companies over time has also trended upwards since 2011. However, when the private company market is broken down by size of annual revenues, smaller accounts appear to still be seeing RPM reductions.



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Private companies in the Advisen database with annual revenues below $50 million have seen the flattest RPM curve, with recent activity seeing the RPM hit a 10-year low $6,600 in 2007, before rising to float around the $7,000 per million mark from 2008-2012. The lack of peaks and troughs in this size account may be a strong indicator of the minimum economically-viable rate for writing D&O insurance.

Private companies with annual revenues between $50-250 million also demonstrated a relatively flat RPM over time. Having fallen steadily since 2003, the RPM for this group of private companies reached it's nadir in 2007 at around $11,000 per million. It then leveled-off in 2009 at around $12,500 per million, before falling again in 2012 to average $11,000.

However, there is a lot more volatility in the next category of private companies. The average RPM paid by private companies with revenues between $250 million and $1 billion dipped below $10,000 in 2011, before bouncing back to $15,000 in 2012.

Conversely, the largest group of companies (greater than $1 billion revenues) has not seen the same level of rate hardening, with RPM still dragging around 10-year lows in the $10,000-range.

On the ground…

Of course, the above references are general views of the market based on Advisen data. Anecdotally, carriers tell us that rate increases of around 10 percent are being achieved at the beginning of 2013 on private D&O accounts, with up to 30 percent rate increases being applied at renewal for certain accounts. However, this does not include rate changes on business that changes hands at renewal, which may be renewing at little or no increase over expiring rates.

Carriers report that the perceived underwriting profitability of the private D&O sector had attracted new entrants to the space in the past five years. As with most market corrections, pricing had to reach a floor before economic momentum turned the market upward again.

Market commentator Richard Betterly reported that respondents to a 2012 private company management liability insurance market survey "for the most part carriers with large books of business are edging their rates up 5-10 percent, sometimes more, even at the cost of losing some insureds".

"This seems particularly true for the carriers that write a lot of smaller employers," he added.

According to Advisen market research, the correction is not focussing on claim-afflicted accounts, but market participants point to a "re-underwriting process" occurring across the portfolio.

Underwriters are assessing the package of premiums, self-insured retentions and coverage to reflect the actual risk profile of private and non-profit accounts, rather than succumbing to competitive pressure as had been the case in the previous five years.

Specific industry sectors are seeing higher rate increases, based mainly on claims experience (which we will discuss further in Section 9 of this report). The non-profit areas of healthcare and education are undergoing considerable underwriting realignment. Private education has also attracted D&O claims and is therefore a pocket of harder rating than other sectors. Technology, telecoms and sports teams and bodies (such as the NFL, NBA) have also experienced higher loss ratios in recent years are warranting larger rate increases.

Geographically, California, Texas, Florida and some mid-western states including Michigan, have some of the highest claim frequency and severity. Carriers report imposing higher rates, self-insured retentions and restrictive cover in these territories.

A bit on the side…

D&O cover first trickled through into the private company market from the public sector in the early 2000's and has now established itself as a standard purchase alongside employment practices liability for those private companies that buy insurance protection.

The take-up rate of some of the ancillary covers offered in a private D&O package varies, however, according to the market cycle.

Limits are often purchased separately for each line of cover, including EPLI, D&O, Crime, Fiduciary, employed lawyers, kidnap & ransom.

Underwriters have described that buyers have increased their purchase of some ancillary covers in recent years. One explanation for this increased take-up is that available budgets for D&O purchase have been able to stretch further as rates have declined. With D&O premiums falling around 23 percent between 2003 and 2007 (see Advisen graphs on page 25), buyers could add the relatively cheap additional covers of employed lawyers or kidnap & ransom.

Time will tell whether, with increased rates on the main D&O coverage, take-up will continue to rise for ancillary covers.

8 Coverage issues

Private matters…

D&O cover for the private company sector varies considerably from that of its publicly-quoted cousin. In this section, we outline the main coverage elements and look at the causes and outcomes of recent wording developments.

At the heart of any D&O insurance policy lies the promise to indemnify the individual directors and officers in the ev ent they are subject to allegations of wrongful conduct in the lines of their duties.

The main cover offered under a private D&O policy is:

- Coverage for claims made against the private company, its directors, officers, managers, full time, parttime and leased employees and its volunteers.
- Subsidiary coverage may include any entity more than 50 percent owned, such as corporations and LLCs
- Typically includes employment practices liability coverage
- Often packaged with other coverages including fiduciary, privacy, crime, kidnap and ransom, miscellaneous E&O, and technology E&O. The covers under this package can have combined or separate limits of liability
- Sub limit for costs and fees incurred in determining whether to prosecute the claims alleged in a shareholder derivative demand
- Reinstatement of limit for individuals for subsequent claims
- Waiver of deductible
- Crisis management costs covered to minimize potential financial and reputational damage arising out of a public relations event

The main exclusions often imposed on a private D&O policy are:

- Fraud and Dishonesty
- Personal Profit
- Bodily Injury/Property Damage
- Pollution
- Prior and pending litigation
- Prior Notice
- Prior Knowledge
- ERISA
- Insured versus Insured
- Anti-trust
- Initial Public Offering of securities
- Breach of contract
- Patent infringement
- Professional services

Different strokes

Crucially, one major benefit offered to private companies that is not afforded public corporations is full cover for the entity in addition to the directors and officers. This extends a substantial amount of balance sheet protection to the private company.

According to lawyer John E. Black , there are three major coverage differences distinguishing private company D&O from public company:

- Full entity coverage
- Cover extended to employees
- Often written as a duty to defend cover, with option of duty to indemnify

Cover expands…

As with many products competing in popular and dynamic marketplaces, the details of the coverage are constantly evolving. The trend over recent years has been towards a general broadening of cover afforded to private companies, their management and their employees. This broadening has been driven by the ever-changing economic, litigious, and regulatory environment in which corporations operate as well as an increasingly competitive insurance underwriting environment.

Below are a few examples of recent policy wording developments:

The Levy language: A 2007 Delaware Chancery Court case, Levy v. HLI Operating Co Inc , changed the way private equity-owned companies are required to advance expenses and indemnify private equity representatives on company boards.

In the Levy case, the Delaware court ruled that, where there is no express agreement to the contrary, the portfolio company and the private equity investor might both owe indemnity obligations to a director sitting on the board of a portfolio company and thus would “share” responsibility for indemnification obligations in some respect .

Coverage has broadened to buy-back the element of co-indemnity between the private equity investor and its portfolio company.

Insured versus Insured carve-outs: Most D&O policies have exclusions precluding claims brought by one insured against another insured, to exclude collusive claims and infighting among senior corporate officials.

Extensions to the Insured versus Insured exclusion include preserving coverage for derivative claims, cross claims and certain employment practices claims. The exclusion is often widened to cover claims brought by trustees, receivers, liquidators, creditor’s committees, bondholder committees, and other bankruptcy constituencies.

Anti-trust: Claims arising out of anti-trust suits are excluded in the base form of a private D&O policy. However, most carriers will offer the cover – with the imposition of a sub-limit of indemnity, an element of co-insurance between the carrier and the insured and a separate self-insured retention.

Rates charged for this buy-back vary according to industry class, with healthcare and telecoms being more susceptible to this type of claim than others.

Even outside of the most exposed industry classes, anti-trust suits can be extremely expensive, with the most impactful element of the cover being the payment of defense costs.

Fraud: While a large percentage of D&O claims include allegations of fraud or illegal personal profiting (or both), the simple allegation is not enough to trigger the exclusion. Most, if not all, such exclusions require something like a court determination of guilt or an admission of guilt before the exclusion can apply.

Either the words “final adjudication” or “in fact” will be used in the exclusion to indicate how high the hurdle is for the carrier to apply these exclusions.

Defense costs incurred for such a claim are typically covered by the policy until such time as the wrongful conduct is determined to have “in fact” occurred, or until there is a final adjudication. This means that a settlement without an admission of wrongdoing usually does not trigger the exclusions.

Severability: Conduct exclusions contained in the policy have become “fully severable”, meaning the alleged wrongful conduct of one individual cannot be attributed to the rest of the insureds under the policy.

IPO of securities: Management liability-specialist lawyer and broker, Kevin LaCroix, highlights the IPO exclusion for particular note .

“The critical distinction between private and public companies is that public companies have publicly traded securities and private companies do not,” he states in his DandODiary blog. “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.”

However, he cautions against exclusions that are worded to the effect they preclude coverage for claims arising from pre-IPO activities, such as roadshows, which 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 private company policy is the one that will respond to the claims,” LaCroix said.

Carriers have been under increasing pressure in recent years to offer a wider range of pre-IPO activities, thereby opening up to some potential unintended claims.

FLSA: Some carriers have also attempted to address some of the emerging issues as discussed in Section 6 of this report. One example is the Wage and Hour provisions under the Fair Labor Standards Act.

Carriers offered sub-limits on Wage & Hour claims, but with typical class action lawsuits costing in the millions of dollars, the sub-limits were extremely vulnerable to exhaustion by defense costs alone. Advisen market research has suggested that the coverage extension was not profitable and carriers have now largely retracted the cover to avoid costly claims.

… and contracts

While the current hardening market for private D&O insurance (as discussed in Section 7) has largely impacted premium rates and retention - and some carriers have opted to withdraw from certain high risk industries such as health care and real estate – there is still a fair amount of pressure to expand coverage, according to carriers who helped Advisen with its research.

However, some coverage contraction is occurring, including FLSA coverage. This extension is one anecdotal example of market competition pushing coverage beyond the intended bounds of a private D&O program and encountering higher-than-expected claims experience.

Anti-trust cover is also in the process of a "re-underwriting" process by many carriers, which are imposing co-insurance, rate increases and self-insured retentions to the extension of cover.

In extreme cases, carriers have been reported to have offered to remove entity cover for a private company in exchange for retaining a flat premium at renewal, thus removing a fundamental element of private company cover.

Other carriers are seeking to increase retentions on D&O policies and even restrict the amount of limit offered overall to a private company at renewal.

9 Claims trends

A non-standard claims experience

Private company D&O claims are varied in their source and in their process, throwing up many idiosyncrasies for carriers and insureds when a claim arises. Well, they say variety is the spice of life…

To re-cap on Advisen's 2013 private company risk manager survey results, almost half of the respondents that did not buy D&O insurance cited a lack of concern over litigation as the main reason for not purchasing.

This is a common misconception among private company owners and executives, especially in those 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 the plaintiffs in D&O claims 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.

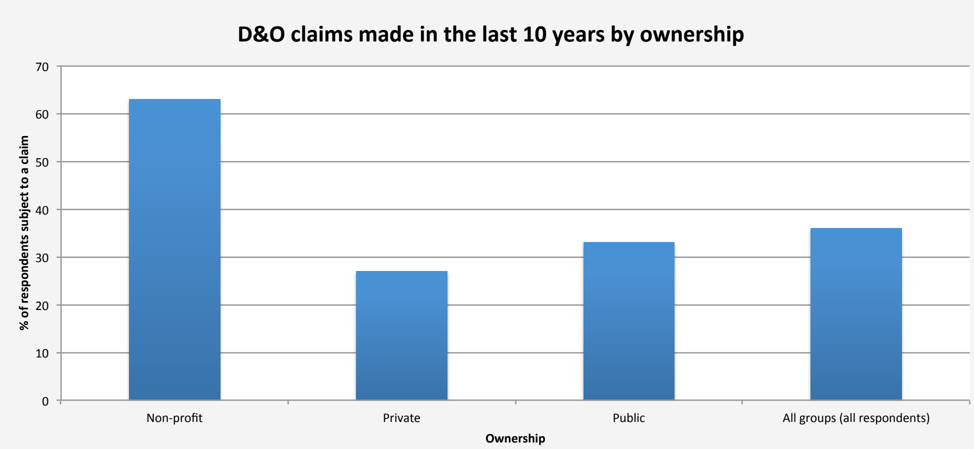
In our litigious age, just about anybody is a prospective claimant.

Claims types

Advisen's 2013 survey highlighted three main claim types suffered by respondents in the past three years: Shareholder suits (46 percent); client-led lawsuits (33 percent); vendor lawsuits (21 percent).

Another significant category included former employees claiming under the EPL section of the policy, which is not within the scope of this report.

Towers Watson's 2013 D&O survey showed that of the 325 respondents across non-profit, private and public companies, 63 percent of non-profit entities and 27 percent of private companies had been subject to a D&O claim in the past 10 years.



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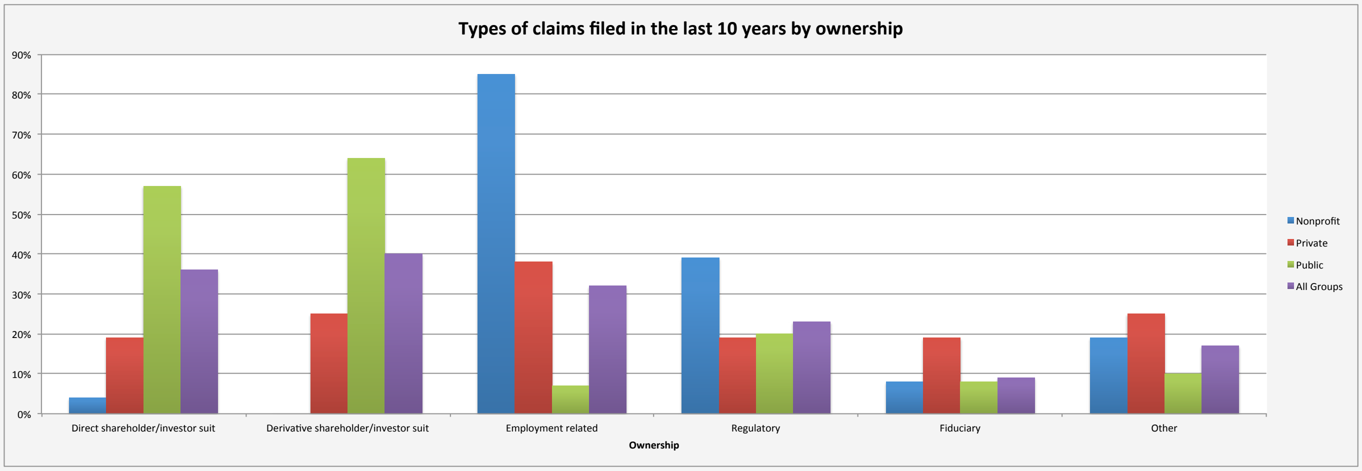

Towers Watson

In terms of the type of suit brought against non-profit companies, employment claims dominated with 85 percent of cases, followed by regulatory claims, representing 39 percent of cases.

Lawsuits against private companies and their executives were from much more varied sources, however, spread relatively evenly across shareholder, fiduciary, regulatory claims. Employment claims remain outside the scope of this report.

Carriers tell Advisen that there are four main causes of claims for private company D&O policies:

- Bankruptcy and creditor actions
- Shareholder suits
- Consumer suits
- Competitor actions

Bankruptcy/creditors

For private companies facing financial difficulty, creditors may call into question the accuracy of financial information they relied upon when they extended credit. Secured creditors may assert mis-management or mis-representation around a credit facility that was in place.

Creditors also have successfully sued directors of failed companies for breach of fiduciary duty and corporate waste, alleging, for example, that directors allowed a company's assets to be squandered. Bankruptcy trustees also may sue to recoup losses from directors.

In some cases, according to John E. Black of Boundas, Starzinsky, Walsh & Black LLC , creditors can step into the company's shoes and assume the corporation's duties when it is in financial difficulty – called the "zone of insolvency". There are two tests to assess whether the company is in the "zone of insolvency": the balance sheet test (whether fair value of corporate liabilities exceed the fair market value of assets) and the cash flow or equity test (the company's ability to produce sufficient cash to pay debts as they become due).

Once a court determines that a company is in the zone of insolvency, the court will determine whether the directors and officers breached their fiduciary duties to creditors.

Non-profit bankruptcy case study

An insured hospital filed for Chapter 11 bankruptcy. A subsequent complaint was filed by the Trustee on behalf of the unsecured creditors against the hospital's board of directors asserting causes of action alleging, among other things, breach of fiduciary duties, fraudulent conveyance, and fraud.

The Trustee's complaint focused on the actions of the board of directors alleging that they did not take the necessary actions in closing down the hospital thereby deepening its insolvency.

The trustee alleged that instead of implementing the aggressive restructuring that was needed to keep the hospital out of bankruptcy, its board focused on keeping the hospital afloat in so that it could continue to collect salaries and bonuses.

The Trustee alleged that the board's failure to take the necessary steps to restructure or close the hospital earlier than it did caused the hospital to incur millions of dollars in additional debt. As a result of the directors' actions, the Trustee further alleged that the unsecured creditors were owed a significant amount of unsecured debt amounting to nearly a billion dollars.

As part of litigation strategy, the Trustee had the case removed from Bankruptcy Court to State Court. The Trustee did this in order to facilitate a jury trial in a jurisdiction that would be sympathetic to the hospital and the services it had provided to the community. It was the Trustee's view that it would be unlikely that a jury in such a jurisdiction would have found that the board of directors had met the standard of conduct required of directors under the states not-for-profit corporation law.

After the expenditure of a significant amount of defense costs (numerous law firms were retained to defend the conflicted defendants), years of complex litigation, and several mediations, a settlement was reached with the Trustee.

Creditor claim case study

In separate lawsuits, senior credit lender and junior credit lender have sued several Insured entities (named insured and several subsidiaries) and related directors and officers for breach of contract, unjust enrichment, fraud, negligent misrepresentation, fraudulent transfer, unlawful distributions, breach of fiduciary duty and alter ego/veil piercing.

The lawsuits allege damages arising out of the breach of Senior Agreements and Subordinate Agreements between the lenders and one of the insured entities, Financial.

The Lenders claim that the Insured entities, Appraisal and Valuation, used inflated appraisals to value Financial's assets that secured the Senior Agreements and Subordinate Agreements. They claim that the named insured failed to oversee and supervise Financial's operations, despite representations to the contrary during the negotiations for the Senior Agreements and Subordinate Agreements.

The lenders also claim that monies were wrongfully distributed from Financial to other defendants. The lenders claimed over $45 million in damages to recover past due indebtedness and unpaid interest and expenses; of which, $10 million was owed to Senior Credit Lender and $35 million owed to Junior Credit Lender. The lenders also sought $3.7 million for improper distributions and attorneys' fees and costs.

The Court dismissed the initial pleadings without prejudice; both lender's filed amended pleadings asserting similar allegations. The lenders took different tactical approaches to their respective litigations.

The senior credit lender and insureds were able to reach settlement prior to any significant discovery exchange. Litigation with the junior credit lender continues. In light of various coverage issues, insured(s) and insurer have reached agreed upon allocation for defense costs and settlement in the senior credit lender lawsuit and for continuing defense costs in the junior credit lender lawsuit.

Shareholder suits

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.

There are two main types of shareholders suits, those that allege a breach of duty to a shareholder (direct) or those that allege a breach of duty to the company (derivative).

Direct shareholder cases almost routinely arise out of merger and acquisition activity, with minority shareholders of the acquired company alleging that they didn't get a fair price, or new owners alleging that financial statements or private placement materials were misrepresented.

Shareholders also assert mismanagement and often assert conflict of interest on the part of the board or majority shareholders, claiming that the individual defendants' prior decisions were made for personal reasons - including their own financial benefit - and not for the overall benefit of the Corporation and all of the shareholders.

Derivative shareholder suit

On October 29, 2009, Stanley Marvin Campbell, Trustee in Bankruptcy for ESA Environmental Specialist, Inc. (ESA or Company), filed a lawsuit in the North Carolina Western District Court against the Company's officers and directors (ESA defendants) alleging claims of fraudulent procurement of funds from a lender.

The complaint alleges that the ESA defendants conspired with contractor defendants, and perhaps others, to divert over $12 million in loan proceeds to their own use through a Ponzi scheme.

The keystone of the alleged scheme was for the contractor defendants to generate invoices for construction services never performed and supplies never purchased, which were in turn presented to Prospect Capital Corporation (Prospect) by the ESA defendants to justify draws on the loan.

As the scheme played out, ESA was unable to repay the debt and sought the protection of the bankruptcy court in this district. In bankruptcy, Prospect purchased the assets of ESA.

Prospect asserts a derivative claim for breach of fiduciary duty and for waste of corporate assets against former officers and directors of ESA, among other complaints

On November 28, 2011, the Court approved a $2.25 million settlement between Prospect and the defendants.

Internal disputes

In May 17, 2012, a Dallas County physician who suffered financial losses after investing in two North Texas diagnostic medical imaging centers was awarded a $10.66 million verdict after jurors agreed that his business partners (Mehrdad "Mike" Ghani and Dr. Michael Taba) made an orchestrated effort to misappropriate the partnerships' funds and assets.

The plaintiff alleged among other things, that Ghani worked to deprive Cruz of his interests in North Dallas Medical Imaging, L.P., and Plano AMI, L.P., two businesses that provided MRI, CT, and other medical imaging services.

The verdict included $2.89 million in actual damages and another $7.77 million in exemplary damages, which jurors added after finding that Ghani's and Taba's actions were malicious, grossly negligent or fraudulent

The jury also agreed that both Ghani and Taba violated their fiduciary duties by opening a competing imaging center without obtaining consent from Cruz or the other Plano AMI partners. Jurors also found that Ghani misled Cruz concerning the financial condition of the North Dallas business and violated his fiduciary duties by providing undisclosed compensation to himself, Taba, and Ghani's wife.

Consumer suits

Consumers of private company goods and services have a number of recourses for action against suppliers, with the most common private company cases including harassment, privacy violation, breach of contract, mismanagement and deceptive trade practices.

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, unwanted solicitations and discrimination.

Text bombardment

The Plaintiff brought a putative class action complaint for violation of the Telecommunications Privacy Act ("TCPA"), seeking damages and injunctive relief. The TCPA prohibits text messages to cell phones made without prior express consent.

The Plaintiff alleged that she received telemarketing text messages to her cell phone from the Defendant/Insured retailer for an extended period of time. Plaintiff alleged that she never consented to receive such messages.

The Plaintiff's cell number was obtained at point of sale ("POS") and a subsequent investigation revealed that the Defendant retailer most likely did not obtain Plaintiff's "prior express consent" to receive text messages. The retailer determined that upwards of 100,000 mobile numbers were likely obtained from POS without "prior express consent" and that upwards of 600,000 texts may have been sent to such mobile numbers.

The TCPA provides for statutory damages of $500 per violation, i.e., for each unconsented-to text message. Additionally, the TCPA provides for an award of "treble the amount of statutory damages" in the event it can be proven that the retailer "willfully or knowingly" violated the TCPA. Despite the relatively small amount of damages per violation, the combined total number of potentially unauthorized texts in this case presented major exposure.

The defendant's D&O carrier had issued a Policy that provided for certain instances of third party violations coverage with respect to certain claims of harassment or civil rights violations brought against an Insured by customers or vendors.

With some uncertainty over whether the text messages constituted "harassment", the carrier agreed to acknowledge potential Third Party Violation coverage and advance defense costs pending the discovery process in the litigation. The carrier reserved its rights as to what portion of the plaintiff class, if any, actually suffered "harassment" and therefore indemnity coverage could be limited. The Insured retailer countered that even a single unwanted text message could constitute harassment. Given that liability was reasonably clear, and the potential damages significant, the parties, along with the carrier, agreed to engage in an early mediation effort. The claim was resolved with contributions from both the carrier and the retailer Insured.

Competitor actions

Suits by competitors often include allegations of antitrust or unfair competition. Other allegations found in lawsuits by competitors include misrepresentation of a competitor's products, infringement of a competitor's copyright or trademark, interference with business or a business opportunity, theft of trade secrets, defamation, inducing customers to breach contracts with a competitor, and enticing employees to leave a competitor.

These types of claims are particularly prevalent in the non-profit sector – particularly healthcare organizations, educational institutions and sports teams and organizations.

These cases sometimes involve complex areas of the law, and can be expensive to defend. As previously discussed, antitrust cover is often offered with a sub-limit of liability and attracts additional premium.

An example of a non-profit antitrust cases involves hospitals that offer ambulatory services. Municipalities within close proximity of a hospital may enter into exclusive contracts for ambulatory services. Litigation can be initiated by a company who properly submitted a bid who was not awarded the contract, alleging the hospital that was awarded the contract violated the antitrust statutes. Specifically, allegations include that the bidding process was not conducted in a competitive fashion.

Other hotspots for antitrust litigation are educational establishments. Universities have received suits from students saying they had been misled into thinking they would get a job after graduating.

Hospital antitrust case

On August 6, 2012, the state of Nevada brought an action against Renown Health in Nevada District Court over alleged violations of the antitrust laws.

In late 2010 and in March 2011, Renown Health acquired two leading cardiology firms - Sierra Nevada Cardiology Associates and Reno Heart Physicians , making it the employer of 97 percent of the cardiologists firms in the Reno-Sparks area.

According to the suit, the company required its physicians to sign a contract, barring them from practicing their profession for two years after leaving Renown. This resulted to elimination of head-to-head competition in an already highly concentrated market, the lawsuit added. The complaint charged Renown Health with violations of the Clayton Act and Nevada Unfair Trade Practice Act.

On August 13, 2012, a settlement was reached by the parties. Under the agreement, Renown must notify the attorney general of any plans for acquisitions that affect cardiology services in Nevada. It also must implement an antitrust compliance program, and pay $550,000 for investigative fees and other costs.

Hands-on claims approach

The private company sector shares many fundamental characteristics with public companies, but it also has a number of crucial differences, which makes claims handling of private company D&O cases a unique skill.

Private companies are often smaller entities, with streamlined organizational structures. This may mean that they don't have a dedicated risk manager or internal counsel. In this case, when a D&O claim does arise, the onus falls more squarely on the D&O insurance carrier to support the directors and officers through the claims process.

Often, a D&O lawsuit is the first one that a private company has experienced and the company owners and executives can be unsettled by the unwanted attention and distraction of handling the defense. Public companies, on the whole, are more circumspect and less emotional about litigation and have procedures in place to handle the discovery phase and work with their insurance carrier to reach swift settlement.

However, in the private company sector, carrier claims executives often have to lead proceedings, to remove some of the emotion that can cloud director's and officer's judgment.

With less onus on private companies for public disclosure and fewer rules around reporting and record-keeping, the discovery phase of a claim process is often more protracted in a private company.

A private company may not have procedures in place to back-up emails on hard drives, or keep employee handbooks, standardized financial statements etc. The lack of these processes can result in an increased need for depositions and document recovery.

These additional procedures increase the expenses allocated to a claim and can erode limits available for settlement. It is essential, therefore that insurers have a valid defense, but also engage plaintiffs early enough on settlement to ensure there are limits available to the insureds. In private company cases, very few cases go to trial, with most settling out of court.