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## Why Private Companies Need Director & Officer Protection

It's important for you to understand the many risks you face as a director and/or officer of a privately held company. This review will provide valuable perspective on these exposures, concerns of similarly situated executives, and insight into vulnerability to these risks.

Many private company executives understand that they and their fellow directors and officers are at risk from lawsuits filed by investors, customers, and others. While private-company litigation is less prevalent than risks faced by public companies, nonetheless the risk exists.

Obviously, it is prudent to take steps to minimize these exposures. Such steps include the purchase of D&O Liability insurance, and instituting a corporate governance program. Professional help (such as HR consultants and specialized attorneys) should be utilized to establish policies and procedures.

Almost 20% of executives or their companies have been sued during the past few years. Many officers and directors believe that there is no threat of a director or officer liability lawsuit because all the stock is "closely held." Nothing could be further from the truth. Only 40% of all D&O lawsuits came from shareholders! The remainder of the lawsuits against directors and officers come from employees (existing and former), unions, customers, competitors, banks and other lending institutions, suppliers, governmental entities, acquisition targets, vendors, and others.

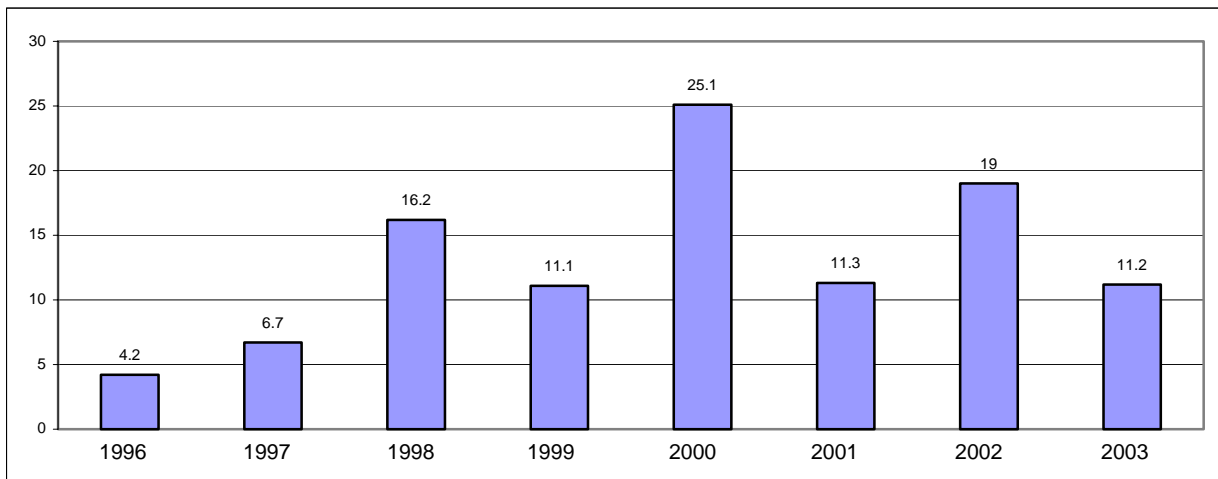
The term "Director & Officers Liability" ("D&O") refers to the personal liability that can be incurred by persons serving as company officers or members of a corporate board for their acts or decisions in that capacity. Normally these exposures are associated with large, publicly traded companies. Most of the large, publicized lawsuits do involve publicly traded companies. In fact, firms with less than 500 shareholders are more than half as likely to experience a claim as more widely owned or publicly traded companies.

One of the popular misconceptions is that directors and officers of privately held corporations do not face the same risks as their counterparts in publicly held corporations. And even though the risk of being sued is less, the financial impact could be just as great, if not greater, on a proportional basis.

This article explains the many ways that directors and officers of privately held companies can be sued, and why privately held companies should seriously consider purchasing Director & Officer Liability Insurance.

### **Securities Class Action Settlements**

*(settlement figures in \$ millions)*



### **Director & Officers in Public and Private Companies Face Many Of The Same Exposures**

Directors and officers of privately held corporations face virtually all the same risks as their publicly traded counterparts, even risks associated with the securities laws of the United States.

Just because the corporation is not publicly traded does not mean it has not issued a "security" that is subject to U.S. securities laws. Many forms of instruments can be classified as a security by the Security and Exchange Commission.

In addition, directors and officers of privately held corporations owe the same duties to shareholders as their counterparts in publicly traded corporations (i.e., duties of loyalty, diligence, obedience). And it is no safe harbor that, for example, all the shareholders of a privately held corporation are relatives or friends. Friends may one day become bitter enemies, even when they are relatives.

Directors and officers can be held personally liable for corporate debts where that person signed the debt document or performed related activities in a way that was outside his or her scope of authority.

There are virtual minefields of potential problems that face officers and directors during a merger / acquisition transaction.

Also, there is no safe harbor to protect a director or officer of a privately held corporation who is merely acting on behalf of the corporation. The individual can

still be personally liable for his or her acts on behalf of the corporation. Directors and officers of privately held corporations may have more risk of claims because most privately held corporations simply do not have the same resources as large publicly traded corporations, so that many decisions by directors and officers of privately held corporations are made without full or accurate information.

In short, there are a myriad of activities performed by directors and officers of privately held corporations that may give rise to lengthy and potentially costly litigation. Even though the odds of being sued are less than for publicly traded corporations, the risk is still there and should not be ignored.

### **Potential Litigation Sources Are Extensive**

There is a large and ever growing list of people and entities that can bring suit against a director or officer of a privately held company. Here are few examples:

#### *Claims By Shareholders And Future Perpetuators*

A variety of different types of shareholder claims have made in the past against directors and officers of privately held corporations, and will continue to be made, particularly from minority shareholders.

Some claims allege there were breaches in the duty of candor with respect to misrepresentations in and/or omissions from private placement materials. Some claims allege there were breaches of the duty of care with respect to how the directors and officers handled the sale of the corporation, or how they missed a great opportunity for the corporation.

There are a rising number of claims being brought by future perpetuators of privately held corporations. In these cases the perpetuators are promised a degree of future ownership in exchange for their staying with the organization and foregoing outside opportunities. Future perpetuators may bring claims alleging misrepresentation of future opportunities, profits and corporate growth.

Some claims allege there were breaches of the duty of loyalty with respect to deals the corporation had entered into with companies owned in whole or in part by one or more of the directors and / or officers.

#### *Claims By Employees*

Several types of claims have been made by employees, with alarming frequency, in the last several years, especially in the area of breach of employment contract.

Union employees, either individually or collectively, may sue directors and officers for breach of the labor agreement, or for alleged misjudgments that forced layoffs or wage / benefit reductions.

To the extent that a company's profit sharing performance is directly tied to breaches of duty by directors and officers, employees may bring suit for lost benefits.

### *Claims By Customers and Suppliers*

Directors and officers of privately held corporations face claims by any party with which the corporation contracts or even discusses a contractual relationship (whether a customer, supplier or other contracting party). Because many contracts and other negotiations for privately held corporations are often handled by an officer of the corporation, they are at risk for claims arising out of their contracting and negotiating activities.

As it pertains to customers, this could include the non-performance or delivery of product or services or the failure to enforce quality standards.

As it pertains to suppliers, this could include the failure to honor long-term purchase agreements due to alleged errors in judgment or wrongful activity on the part of the director or officer.

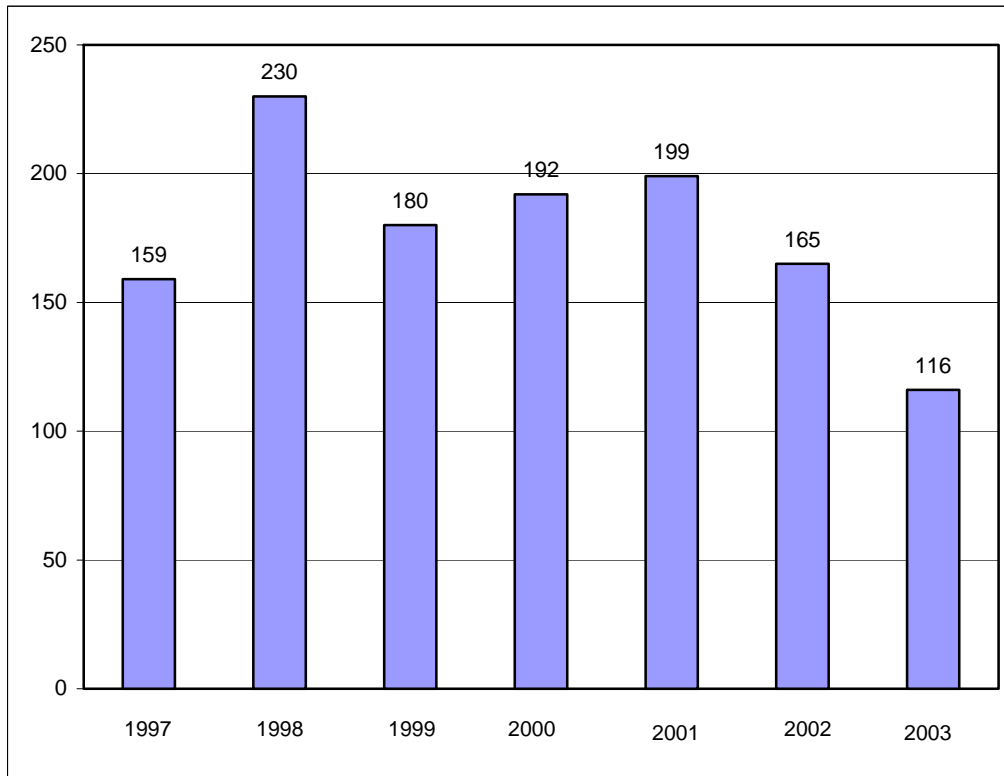
### *Claims By Competitors*

There are times that a privately held corporation will hire a key employee away from a major competitor and, in the process, the competitor alleges misappropriation of trade secrets, customer information, or a violation of the former employee's termination agreement.

### *Claims By Government Agencies*

A variety of claims can be made by government agencies against the directors and officers of privately held corporations. Such claims vary from those relating to environmental contamination to employee health and safety. In addition, privately held corporations in certain industries can face investigations and claims by regulatory agencies alleging suspected wrongdoing. Governmental agencies can bring suit to include all federal, state and local agencies.

## D&O Securities Class Action Filings – Non-Fortune 500 1997 - 2003



### The Financial Stakes Are Enormous

Any director or officer of a privately held corporation who does not insist that their corporation purchase some form of D&O insurance, runs a huge risk. Defense costs alone for director and officer claims are enormous. Average payout to claimants, while they occur less than 20% of time, average over \$2,000,000!

If no Director & Officer Liability insurance is available for these types of claims, the money will inevitably come from the personal assets of the individual. Spouses and estates of directors and officers also are exposed to these liabilities.

### Check Indemnification Agreements

Irrespective of your state of incorporation, there are statutory indemnification requirements that must be provided to directors and officers of corporations. In addition, corporations are free to expand this contractual obligation in many ways.

Indemnification agreements create a financial obligation that must be honored at the time a breach of duty, as defined by your corporate bylaws, is committed.

This financial obligation normally entails defense costs as well as the legal obligations created by breach of duty.

These financial demands can be significant at the time of loss and impose a large, unplanned drain on the resources of the privately held corporation. A D&O liability policy can insure this contractual obligation.

### **Standard Liability Policies WILL NOT Respond**

Your General Liability policy is designed to insure your company against third party allegations of "bodily injury," "property damage," "advertising injury," and "personal injury" as defined in the policy. Your officers and directors (as defined by your corporate by-laws) are also insured under this policy automatically while they are operating within the scope of their duties.

This policy, however, is NOT designed to insure your corporation for any obligation under any corporate indemnification agreements, or for any "wrongful acts" performed by the director or officer created by breaches in duty. Therefore, there is no recovery under your standard liability insurance policies for these exposures.

### **Outside Directors May Demand This Coverage**

Increasingly, outside board members of privately held corporations require that they be fully insured under a D&O policy as a precondition for accepting the position. In fact, many are requiring an independent review of the policy itself to make sure that it is state-of-the-art and adequately insures their interest.

Privately held corporations are recognizing that they must have a properly designed D&O liability policy in order to attract outside advisory talent.

### **D&O Protection Is Affordable**

Several insurance companies offer both broad coverage and high limits of liability - at realistic premiums. It is even possible to "package" director and officers liability insurance coverage along with other "executive risk" coverages, such as fiduciary liability and employment practice liability, thereby generating additional premium discounts.