

D&O Insurance for Private Companies and Nonprofits

By **Caren Braun**

As a director, officer, or trustee of a closely held private company or a nonprofit, why do you really need Directors & Officers (D&O) liability insurance? This article provides an update on what exposes assets of private company and nonprofit directors and officers to risk; addresses common areas of litigation against directors and officers; and offers some key coverage issues directors should consider when procuring a D&O policy in the current marketplace. This article does not address other management liability coverage that often comes bundled with D&O insurance, such as employment practices and fiduciary liability protection, although the importance of closely examining these coverage provisions cannot be overstated.

The Importance of D&O Protection

Primarily, D&O insurance serves to fund the defense and indemnity for lawsuits arising out of the management, or alleged fraud or mismanagement, of your company or nonprofit. D&O policies in today's market are very broadly worded and can, in many respects, be considered "all-risk" protection for directors and officers, except for that which is excluded.

For private companies, litigation naming directors and officers may stem from early investors in the companies alleging dilution of their interest due to subsequent financing rounds or mismanagement, or from later investors alleging inadequate or inaccurate disclosures in financial statements or private placement materials. Litigation may also arise from competitors, clients, current or former employees, regulatory entities, bankruptcy trustees, and

potential acquirers or acquisition candidates for a myriad of reasons, many of which are discussed below.

Litigation against nonprofit directors and officers can arise from the nonprofit's members, current or former employees, other board members, donors, competing organizations, and regulatory agencies. Allegations may include, among other things, fraud and mismanagement, antitrust violations, negligent peer review, negligent accreditation and standard setting activities, libel, slander, plagiarism, privacy, and IP infringement.

Although it can be anticipated that a company or nonprofit will be responsible for indemnifying its directors, officers, or trustees in most situations, there are several situations when this is not possible or permissible and personal liability may exist. These situations are as follows: (1) insolvency; (2) prohibition by public policy (in instances of fraud or in many states derivative suits, for example); and (3) lack of adequate indemnification provisions in the corporate charter or bylaws, if indemnification is not required by state law. D&O insurance may provide coverage for these types of non-indemnifiable claims, as well as fund the defense and indemnity for an organization's indemnification obligations to directors and officers when required to do so. (Note: An organization's bylaws and indemnification provisions should be periodically reviewed by counsel and dovetail with the D&O policy, especially if the policy contains a less than favorable presumptive indemnification provision.)

Key Coverage Issues to Consider

The current D&O insurance market remains highly competitive in terms of both pricing and availability of terms, and multi-year policies are once again becoming available. Some of the key coverage features to consider when looking at your current or prospective D&O policy are outlined below. If not already included in your policy, the D&O insurer's willingness to modify your coverage depends on your risk profile,

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Director Summary: There are many reasons for directors of nonprofits and private companies to consider D&O liability insurance coverage for both the company and the board. Knowing which type of insurance will cover what type of claims can gird you and your board for any legal risk.



the size of your overall account, your broker's expertise, the relative importance of a particular coverage grant to you, and ultimately, the flexibility of the underwriter.

Coverage for non-indemnifiable, indemnifiable, and entity claims

These are often referred to, respectively, as A-, B-, and C-side coverage. Ensure that the A-side portion of your policy—which protects the individual directors and officers—is non-rescindable in its entirety. You might want to consider a supplemental A-side DIC (Difference in Conditions) policy for additional protection, although an order-of-payments provision in your policy will somewhat mitigate the need for this. A well-crafted D&O policy will waive the retention in the event that no liability is found or settlement reached for B- and C-side claims. “Insureds” under the policy should include past, present, and future directors, officers, employees, the company or nonprofit itself, advisory boards, committees, or similar entities. Pay particular attention to what coverage you want to extend to leased, temporary, or contract employees as policies vary on coverage. Coverage for subsidiaries should be automatic with preferably no reporting requirement.

Coverage for defense costs

Do you have choice of counsel? Make sure you understand when, and how, the legal bills and retentions are paid, and what counsel you can use, prior to binding coverage. More often than not, lawsuits will contain a variety of allegations and parties to the same, some of which will be covered while others are not. A “duty to defend” feature is very valuable and should obligate the insurer to defend the entire lot. However, some D&O insurers will allow you to utilize your own counsel for a D&O claim (atypical for employment practices liability claims) but be sure you understand how the allocation of what is covered and not covered will be handled should you choose this route.

Coverage for losses covered by other insurance policies

While D&O policies will all contain exclusions for these types of claims—i.e., property damage, bodily injury, and ERISA claims—ensure that the exclusions are worded so that the carrier can apply exclusions in only the narrowest of contexts. D&O policies normally contain an excess insurance clause, so be sure to examine this closely whenever you think other insurance might respond. This is particularly relevant with respect to personal and advertising injury protection that should be provided in nonprofit D&O policies.

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Coverage for breach of contract claims against individual directors and officers

While a private company itself will not be protected for breach of contract claims by a D&O policy, (except if the suit is brought alleging shareholder loss from the breach), the individual directors and officers should be. Nonprofit D&O policies should afford the same or better protection but can be ambiguous, so be sure to examine closely and clarify intent. If the D&O insurer adds a professional liability or any other unique exclusion to the D&O policy, ensure that the policy has an exception for claims brought against the individuals related to the mismanagement of the company or nonprofit, and that the plaintiff need not be a security holder or member for coverage to apply.

Coverage for intellectual property claims

Just as with breach of contract claims, a private company itself will typically not be insured in these types of suits (except if a suit is brought alleging shareholder loss related to the IP claim); however, individual directors and officers should be covered. This protection should extend to claims alleging infringement of patent, copyright, trademark, or other IP. Again, nonprofit D&O policies can go a step further and extend some IP coverage to the organization itself. However, as mentioned above, D&O policies contain excess insurance clauses so be sure to examine these closely and modify according to your needs.

Coverage for claims brought by other insureds under the policy

While a private company D&O policy excludes claims brought by one insured against another, it should provide exceptions for suits brought by former directors and officers that have been gone from the company for four years or less for EPL claims, derivative demands, bankruptcy trustee, and cross-claims. A well-crafted nonprofit D&O policy should go one step further and provide full coverage should an individual director or officer commence litigation against other board members or the



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entity itself, as well as provide coverage for derivative suits brought by the members.

Coverage for capital-raising activities

Ensure the D&O policy responds to claims involving any and all debt—tax exempt or not—and private-equity placements that might be applicable to your organization, including “road show” activities for private companies.

Coverage for innocent insureds

A good D&O policy will preferably contain “full severability” of the application and all exclusions for insureds, including the company itself, in the event that fraud or unethical activity is uncovered. Ensure “final adjudication” wording is written into dishonesty and fraud exclusions. If the application and financials become part of the policy, seek to have the underwriter rely only on the last twelve months of financial information, on a rolling basis if possible.

Coverage for nonprofit board service

This is often an overlooked but valuable coverage that can be found in private and nonprofit D&O policies, provided that service is with “consent and at request of” the insured company. Be sure to have documentation of this on file. Conversely, a claim pertaining to an outside board position can erode the limits available for current directors and officers. Again, D&O policies always contain excess insurance clauses so be sure to examine these closely and modify accordingly.

Coverage for formal regulatory investigations, unfair business practices, and antitrust claims

Complex and costly claims can be brought by competitors as well as federal, state, and local governmental agencies; ensure no exclusion precludes coverage in these instances and that an individual need not be named in order to trigger the coverage. With respect to whether the policy will respond to “informal” regulatory inquiries that will require attorneys to get involved, coverage can be ambiguous, so be sure to tailor policy accordingly.

Coverage for full prior acts and continuity

Ensure that your current or prospective underwriter does not require you to “re-warrant”—or disclose any known

circumstances that might give rise to a claim—prior to the date you last answered a warranty question on a D&O application. Further, be sure they do not have an exclusion for same. A good broker will be able to advise on the best strategy to report circumstances and claims prior to expiration of your D&O policy and/or switching carriers. Full prior-acts coverage can and should be obtained back to the founding of a company or nonprofit for first-time D&O buyers, if warranty questions are answered.

Coverage for worldwide activities

If you are doing business overseas, be sure that the policy will respond to claims that are brought anywhere in the world. Make sure you understand how the broker and carrier will act on your behalf in the event of same, particularly in countries that require locally admitted insurance. Multiple approaches can be considered regarding the latter, and you must balance compliance, coverage, cost, and administrative issues to determine what is best for your organization.

Determining an Appropriate D&O Limit

Determining what D&O limit a private company or nonprofit organization should carry is largely a subjective endeavor, but the following items should all be considered:

- total assets; total amount of outside investment; donations; endowments; personal net worth of, and limits desired by, individual directors and officers.
- planned changes in equity structure; planned changes in business model or mission; and planned M&A activity or exit strategy.
- significant deterioration in financial condition; dilution of limits by sharing with other coverages; and the complexity and nature of your business, clients and industry.
- D&O benchmarking data and peer data.

Remember, defense costs are almost always included within the limits of liability, so limits can erode very quickly given the severe nature of many D&O claims and the cost necessary to effectively defend them.

Conclusion

The D&O liability insurance market today remains competitive and dynamic but, as with all cyclical markets, it will not last forever. The current climate creates opportunities for directors of private companies and nonprofits to maximize D&O coverage terms, manage costs, and effectively transfer some of the risks of doing business in today’s environment to insurance. ■

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