

**D** Smart  
decision  
makers are

**&**

**O** protecting  
themselves  
and their  
companies.

Why do Privately-Held Firms Purchase  
**Directors & Officers Liability?**



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## Do privately held companies need D&O?

A recent survey of 451 executives of privately owned companies produced some startling facts:

**26%** of the companies experienced a D&O suit in the past 5 years. That is 1 in 4!!

**31%** of the companies with more than 50 employees have experienced a D&O suit. At 250 employees the percentage increases to 39%.

The suits come from a variety of sources:

- **43%** came from customers
- **29%** came from government or other regulators
- **17%** came from vendors
- **11%** came from partners or other owners

The suits cost on **average \$308,475**. The companies with D&O insurance had an average loss of \$129,625. Those without D&O insurance had an average loss of \$408,469.

Most private companies do not buy D&O.

- **75%** of those with fewer than 50 employees don't buy the coverage
- **62%** of those with 50-249 employees don't buy the coverage
- **49%** of those with over 250 employees don't buy the coverage

The reasons given are astounding given the number of claims:

- **33%** believe there is "no need"
- **20%** believe there is little or no risk of loss
- **12%** actually believe the claims would be covered under their other policies

Note this survey just addresses D&O type losses and does not include claims from employees for EPLI type actions.

# DIRECTORS & OFFICERS LIABILITY EXPOSURES OF PRIVATELY-HELD COMPANIES

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# **DIRECTORS & OFFICERS LIABILITY EXPOSURES OF PRIVATELY-HELD COMPANIES**

## **Why Companies Purchase D&O Coverage**

### **D&O is written to:**

- Protect the personal assets of a company's directors and officers;
- Protect the company's assets;
- Provide reimbursement to the organization to indemnify D&O's for their losses; and
- Help the company monitor and provide defense costs associated with responding to lawsuits and investigations.

## **Why Private Companies Should Consider Buying D&O Liability Coverage?**

- Cost of defending corporate lawsuits may exceed the net worth of most private companies;
- Judgments can be financially crippling;
- Corporate indemnification may not be available;
- Adverse shareholders and other potential claimants may exist;
- Bad business decisions are likely to be more visible due to small business environment thus attracting the attention of shareholders, regulators and others;
- Business decisions made by D&O's can quickly impact the finances and operations of a company;
- D&O's work in demanding environments as they cover more corporate duties;
- Unique conflicts of interest may exist due to complexity of responsibilities; and
- Companies will have a difficult time attracting qualified individuals to their Boards without D&O coverage.

## **Current Business Trends Point to Purchasing D&O Coverage**

- Economic uncertainty;
- Access to adequate capital;
- Keeping up with technology;
- Internet growth;
- Protecting intellectual property assets; and retaining qualified workers.

## JUST BECAUSE YOU DID NOTHING WRONG DOESN'T MEAN YOU WON'T BE SUED

No matter how groundless the charges, or how “airtight your defense, D&O litigation can be distracting and financially disruptive for the directors and officers involved – as well as for the private company itself. In a D&O lawsuit, the named directors and officers can be held personally liable for the damages claimed.

Even if corporate bylaws and state statutes provide for the indemnification of a company’s directors and officers, D&O litigation may come at a time when the company cannot afford a drain on both cash and human resources. And, in certain situations, indemnification is not permitted by law regardless of a company’s ability to pay for the claim.

Directors & Officers Liability provides coverage for settlements, judgments and defense costs arising out of the wrongful acts of the directors and officers. It reimburses the private company for indemnification of its directors and officers. If indemnification cannot be made, then the policy pays the directors and officers directly. Due to the catastrophic nature of D&O claims, the purchase of Directors & Officers Liability coverage is strongly recommended for all corporations, including privately-held companies.

# DIRECTORS & OFFICERS LIABILITY CLAIM SCENARIOS

**D&O claim examples are for illustrative purposes only. These examples are not intended to provide legal advice or to be relied upon in any dispute. Every claim is unique and bound by all terms, conditions, declarations, exclusions, and endorsements specific to each Insured's policy.**

## Non-Entity EPL

Plaintiff agreed to help form and work for a company as its Chief Operating Officer. He alleges that his employment was terminated without cause. Further, it is alleged that the company hindered his attempt to find new employment by telling third parties that the plaintiff is prohibited from using trade secrets and intellectual property that allegedly belongs to the company. A complaint was filed against the company and a D&O which included causes of action for breach of contract, and unfair and deceptive trade practices.

Defense costs and settlement for the individually named defendant exceeded \$180,000.

## Creditor Claim

Plaintiff filed a complaint against individual D&Os of a company alleging that it's CEO, CFO, & COO conspired to use the plaintiff's services to furnish, install and repair the company's equipment knowing that it was insolvent and was planning to file for bankruptcy protection. Causes of action included: (1) fraud, misrepresentation and non-disclosure; (2) deceptive trade practices; and (3) civil conspiracy.

Total settlement and defense of the individually named defendants exceeded \$100,000.

## Class Action Complaint

Plaintiffs represent a class of non-insider stockholders who invested in the company. Plaintiffs allege that certain directors and officers failed to disclose material facts and provided them with inaccurate and misleading information. It is alleged that the materials did not disclose the high turnover of management and that the company's website had not yet been developed. The company later went bankrupt. The complaint included causes of action for: (1) common law fraud; (2) negligent misrepresentation; and (3) breach of fiduciary duties.

Settled for over \$1 million and defense costs exceeding another \$1.4 million.

## Conspiracy & Negligence

A professional wrestler who competes in a wrestling circuit files a complaint against the organization - and it's D&Os - which procures the talent for individual events across the country. Plaintiff alleges that he was excused by the organization from appearing at an event due to an illness in his family. The organization allegedly deemed that he was not properly excused pursuant to its rules and was suspended for a period of over one year. Plaintiff alleges that the suspension was done in an arbitrary manner and violated his contract. Plaintiff further alleges that his suspension was done in a conspiratorial manner in order to stifle competition. The plaintiff alleges the following causes of action: (1) breach of contract; (2) negligence; (3) fraud; (4) interference with prospective economic advantage/business relations; (5) conspiracy; (6) and intentional/reckless infliction of emotional distress. Plaintiff is not an Employee as defined by the policy.

The matter is currently being defended and defense costs have exceeded \$200,000.

## **Dispute Over Inventorship**

An inventor filed a complaint against a research and development company specializing in medical devices alleging that the company was founded by his former partner for the purpose of stealing his highly valuable and uniquely innovative technology. This technology was the subject of a patent application which listed the plaintiff as the sole inventor. Plaintiff's former partner, in charge of securing the patent, allegedly informed the plaintiff that he must also be listed as a co-inventor for the patent to be filed. When the plaintiff refused, his former partner withdrew the application. With the partnership subsequently liquidated and the application abandoned, the former partner immediately formed a new company and filed a new patent application virtually identical to the plaintiff's but listed the former partner as the sole inventor. In his complaint plaintiff alleges that the company and its D&O (his former partner) misappropriated technology that he developed, and utilized it to establish the research and development company. Plaintiff asserts causes of action for: (1) fraud; (2) negligent misrepresentations; (3) breach of fiduciary duty; (4) conversion; and (5) successor liability.

Defense and settlement of this matter exceed \$1 million.

## **Competitor Disputes**

The plaintiff filed a complaint against their competitor alleging that a former employee, now working at the competition, engaged in unauthorized use of confidential and proprietary information and committed other acts of unfair competition. As a result, the plaintiff alleges it has suffered irreparable and immediate injury. In addition, the plaintiff alleges that the defendant has possession of its confidential information and intellectual property. The plaintiff asserts causes of action for: (1) misappropriation of trade secrets and confidential information; (2) violation of the Computer Fraud and Abuse Act (3) unlawful access to stored information; and (4) unfair competition. The plaintiff seeks: (1) attachment of a computer server; (2) attachment of certain files and documents; (3) injunction – preservation; (4) injunction – proprietary information; (5) injunction – surrender of possession; (6) injunction – non-compete; (7) compensatory damages; (8) exemplary and punitive damages; and (9) attorneys' fees and costs.

Total defense costs and settlement exceeded \$350,000.

## **Shareholder**

The plaintiff alleges that certain directors have exerted complete domination and control over the company and used the company as a vehicle for their own business purposes at the expense of the company and minority shareholders. Specifically, the plaintiff alleges that certain directors helped to renegotiate a service contract and booked all of the revenue during one quarter instead of over the three year life of the contract. The plaintiff also contends that this service contract received steep discounts and would cause other customers to request similar discounts resulting in lost revenue to the company.

The defense and settlement of this case exceeded \$500,000.

## **Misappropriation of Trade Secrets**

A wholesale supplier and distributor of food products meets with a sales representative of a new product line they are considering. The sales representative communicated that in order to develop a long-term exclusive relationship within the designated territory, the wholesaler must provide her with information regarding its business operations, customers, and trade secrets. Later on, the sales representative opened her own wholesale distributorship within the same territory.

This claim is currently being defended and defense costs have exceeded \$450,000.

## **Breach of Investment Agreement**

A company enters into an investment agreement with a third party and agrees not to negotiate with other entity regarding financing or a potential acquisition for a two-week period. During the exclusivity period the company engages in negotiations with another investment group. The third party alleges breach of investment agreement and intentional and negligent misrepresentation.

Total defense costs and settlement exceeded \$350,000.

## **Shareholder Derivative Action**

A shareholder derivative action is taken against a company for breach of fiduciary duties on behalf of the directors. The plaintiffs contend that the defendants have failed to provide them with certain information, such as shareholder listings, financial data and other corporate records. They also allege that certain directors borrowed money from the company without the Board's approval and subsequently these loans were forgiven.

Total defense costs and settlement exceeded \$500,000.

## **Breach of Fiduciary Duty**

A private company agrees to perform market research for a start-up company in the material management industry. In exchange for their services, the company allegedly agrees to pay the private company \$20,000 in cash and 5% of the privately placed issued shares in the company. The company denies that they explicitly or implicitly agreed to pay the private company in stock. The plaintiffs allege several causes of action, including breach of fiduciary duty.

Total defense costs and settlement exceeded \$800,000.

## **Misrepresentation/Deceptive Trade Practices**

A private software company represents that it can write software for a major corporation according to the corporation's specifications; provide maintenance services for four years; and execute updates and upgrades to the software. The private company misses key delivery dates. The software fails key functionality tests and ultimately crashes and becomes inoperable. The corporation decides to withhold payments until certain milestones are met. The private software company allegedly indicates to the corporation that it needs the payments in order to remain solvent. The plaintiff alleges that the private software company represented that it could produce the software and that it was a financially stable company. The plaintiff alleges the following causes of action; misrepresentation and deceptive trade practices; and breach of covenant of good faith and fair dealing.

Total defense costs and settlement exceeded \$1,000,000.

## **Government Agency**

The federal government sued the CEO, the President and other officers of an East Coast manufacturing company for price fixing.

After an extensive trial, the allegations were dismissed due to lack of circumstantial evidence, but the defense costs and fees incurred were in excess \$750,000.



## **Deceptive Trade Practices**

A private company that manages and runs a major natural resource receives a claim against the company and various members of the board of directors. The plaintiff alleges that the board of directors have used their position for their own private benefit and personal advantage, and for the benefit and advantage of their private employers. The plaintiff also alleges that the board of directors assigned a valuable contract without receiving any consideration. The plaintiff further alleges that such assignment also constitutes misappropriation of valuable assets for the benefit of private party in violation of state codes.

Total defense costs exceeded \$250,000.

## **Inaccurate Disclosure**

A class action suit was commenced by various investors who participated in an internet startup company's a Private Placement that raised in excess of \$5 million to fund capital expenses, to provide working capital and to cover operating losses. An investigation made by and through counsel, primarily from corporate records and public records and documents shows that the Private Placement Memorandum contained an unaudited year end balance sheet and statement of profits and losses which were materially misleading.

Total defense costs and settlement exceeded \$500,000

## **Inadequate Financial Reporting**

A technology company received a complaint from an investor who alleges the company improperly induced the plaintiff to issue a note payable to the company. The plaintiff specifically alleges the company made false representations and other false statements regarding the company's forecasted rate of growth and failure to disclose its tax lien. The company defaulted on the promissory note when it failed to make the required principle and interest payments. The plaintiffs issued a demand letter and filed suit against the company.

The plaintiff agreed to accept the company's offer to convert the promissory note to stock in the company, but the defense costs exceeded \$100,000.

## **Loan Default**

A diversified sports product company received a lawsuit against the President, CEO, and Chairman of the Board for not honoring a promissory note. The plaintiff alleges that it lent \$1 million to the company. The company allegedly agreed to pay the funds back within a month pursuant to the promissory note. Despite requests for return of the money, plus interest, the company has not returned the funds to the plaintiff.

Total defense costs and settlement exceed \$250,000.

## **Foreclosure/Unfair Competition**

A shareholder commenced a derivative action against the president of a company which develops and markets chemical compounds, after all its assets were sold. The company entered into an agreement to allow a corporation to test and evaluate its compounds. The corporation subsequently received various patents for the compounds, however, it refused to enter into a licensing agreement with the company. The plaintiff concludes that the company can assert causes of action against the corporation for: breach of contract; breach of fiduciary duty; misappropriation of trade secrets; unfair competition; fraudulent concealment; and intentional misrepresentation. The plaintiff also alleges the company series B shareholders did not approve certain loans. Subsequently, after the company defaulted on the loans, the president decided to execute a foreclosure sale of the company's assets and he advised the

shareholders that he is resigning. The plaintiff alleges that the president did not promptly advise the shareholders of the foreclosure sale and he breached his fiduciary duties when failed to have the Company commence litigation against the corporation that was retained to test its compounds. The complaint is comprised of four causes of action, including: (1) negligence, (2) breach of fiduciary duty; (3) concealment; and (4) unfair competition.

Total defense costs and settlement exceeded \$750,000.

## **Shareholder Claim**

A Midwest domiciled home products company retained an independent research firm to evaluate its new home product. Based on a favorable review by the outside firm, the company raised in excess of \$10 million for the production and marketing of the new product. Prior to releasing the product, the company's internal evaluation team discovered, after extensive testing, that the new product did not work properly. Shareholders have brought suit against the company and the directors and officers for misrepresentation in the offering documents. The plaintiffs assert causes of action for violation of various state securities laws and the Securities and Exchange Act of 1934.

Damages alleged in the lawsuit exceed \$15 million.

# **DIRECTORS & OFFICERS LIABILITY EXPOSURES OF PRIVATELY-HELD COMPANIES**

## **Basic Responsibilities of Directors and Officers**

Generally speaking, directors and officers of corporations must act in good faith and for the best interests of the corporation. A director is required “to use care, exercise judgment, the degree of care, the kind of judgment that one would give in similar situations to the conduct of his own affairs.”

Authorities say that directors must stay informed about the business in which the corporation is engaged and knowledgeable as to its business activities. The mere fact that a person accepts a corporate office and directorship does not necessarily transfer a full knowledge of corporate affairs.

Directors and officers have a fiduciary relationship to the corporation and its stockholders, if any, not unlike a trustee. In fact, they may be treated as “quasi-trustees;” or sometimes as agents, but are not permitted to use the trust property for their personal gain.

## **DIRECTORS ARE CHARGED WITH THREE BASIC DUTIES: OBEDIENCE, DILIGENCE AND LOYALTY.**

### **Obedience**

Directors should keep their activities within the corporate powers granted by charter or by-laws. If they don't, they are usually held liable for their negligent disobedience.

### **Diligence**

The degree of care which an ordinary prudent person would exercise under the same or similar circumstances is the standard by which a director's or officer's diligence is measured. Before making a decision, directors and officers must inform themselves with all information reasonably available to them.

This duty requires not only reasonable behavior with respect to matters submitted for approval, but also requires reasonable inquiry and monitoring of the organization's affairs. Although directors and officers do not insure the integrity of their subordinates or general organizational performance, they are required to implement reasonable programs to promote appropriate organizational conduct and to identify improper conduct.

## Loyalty

Directors must remain loyal to the corporation by putting its needs before their personal needs. For example, they must refrain from engaging in personal activities which might injure or take advantage of the corporation. Directors and officers are prohibited by this duty from:

1. Obtaining secret profits or unfair gain through personal transactions with or on behalf of the corporation.
2. Competing with the corporation to its detriment.
3. Sizing a corporate opportunity.
4. Using material, non-public information for personal gain.

## Officers Other than Directors

Generally, it doesn't matter if a person sought to be held liable is a director, on the one hand, or is a managing officer on the other. Practically speaking, however, a "full-time" managing officer may be held to a higher level of liability than a director who has no hand in the day-to-day operations.

Corporate officers may become personally liable for fraudulent violation of their fiduciary responsibilities.

Insulation from potential personal liability may be ameliorated if responsibilities are performed conscientiously. Responsibilities may include:

- A. Assuring that all legal technical requirements have been met before the corporation begins business.
- B. Keeping informed of the general activities of the corporation and its general business area.
- C. Fully disclosing details of all transactions involving the sales of securities.
- D. Refraining from self-dealing in anything relating to the corporation's business.
- E. Regularly attending directors' meetings and making sure that records show a valid reason for absence.
- F. Expressing objection with board action when in disagreement, and making sure it is in the minutes accurately.
- G. Having knowledge of the duties of the office.
- H. Avoiding any contract to serve personal interests or to assume any position which might bring personal interests into conflict or competition with the interests of the corporation.
- I. Staying informed of the articles of incorporation, code of regulations and bylaws which relate to a director's powers and duties.
- J. Exercising utmost good faith in all dealings with and for corporation and being prepared to defend these actions.
- K. Obeying all statutes requiring specific duties to be performed by directors.

# POTENTIAL LIABILITIES FACING DIRECTORS AND OFFICERS TODAY

The following checklist is intended to give you a better understanding of the many potential exposures directors and officers face today.

## Management, Business and Operations

1. Acquiescence in conduct of fellow directors engaging in improper self-dealing.
2. Aiding or abetting misconduct of others.
3. Avoiding unlawful political contributions.
4. Awareness of internal management controls.
5. Compensation arrangements and reports of compensation committee.
6. Continuing a wrongful practice after learning of its impropriety.
7. Cooperation with regulatory authorities.
8. Corporate acquisition which would result in loss of corporate assets.
9. Corporate financial delinquencies.
10. Counsel's advice as to possible libel or slander.
11. Dealing responsibly with corporate debts.
12. Dishonored corporate checks.
13. Dissent from improper acts of board or committees and recording of dissent.
14. Executive committee proceedings.
15. Extending credit only as warranted.
16. Filing annual and periodic reports.
17. Guarding against corporate payment of bribes or making illegal payments.
18. Inefficient management resulting in losses.
19. Informal dissolution or liquidation of corporation.
20. Infringement of patents, copyrights or trademarks.
21. Minutes of board and of all committees.
22. Misuse or nonuse of electronic data processing.
23. Monthly operational reports and financial statements.
24. Qualifying corporation in other states where it does business.
25. Receiving personal benefit or gain as a consequence of service performed as a director or officer.
26. Reports of auditors and of audit committee.
27. Recording dissent from wrongful acts at meetings not attended, after reviewing minutes.
28. Selling or transferring corporate assets only for adequate consideration.
29. Shirking responsibility.
30. Statements of corporate policy in areas that frequently generate litigation.

## **Informed Business Judgment**

31. Being inquisitive.
32. Consulting legal counsel, auditors and other experts and corporation's officers and managers to obtain information.
33. Decisions based on adequate information and intelligent and advised judgment.
34. Examining reports and documents before signing.
35. Ignorance of corporate books and records.
36. Inspecting corporation's books and records when necessary to keep abreast of its activities.
37. Making reasonable investigations as necessary.
38. Making use of all available information.
39. Registration of statements and other reports and filings.
40. Using expertise of you own and others.
41. Verifying facts in official documents before signing and filing them.

## **Unauthorized or Ultra Vires Actions**

42. Activities in which the corporation engages as being only those permitted by its corporate powers.
43. Compensation and benefits paid to directors and officers, verified for reasonableness.
44. Consulting counsel for advice as to corporate powers under statutes, charter and bylaws.
45. Declaring and paying dividends only as provided in corporate powers.
46. Distributing assets with adequate provision to pay or secure corporate debt.
47. Dividends paid, adequate and not excessive.
48. Obedience to charter and bylaw provisions.

## **Self-Dealing and Conflicts of Interest**

49. Awareness of conflicts of interest.
50. Conduct of fellow directors engaging in self-dealing.
51. Contracts with corporation involving self-dealing.
52. Corporate contracts as corporate assets.
53. Corporate opportunities when seized by directors or officers.
54. Disclosing personal interest in management transactions.
55. Engaging in a competitive enterprise.
56. Inside information used to obtain secret profits.
57. Key employees as corporate assets.
58. Loans by or to corporate officers, directors or shareholders as involving self-dealing.
59. Preference at expense of creditors or other shareholders.
60. Transactions between corporations having common directors.
61. Transactions with other entities in which an officer or director is interested.

## Change of Control Situation

62. Analysis of the nature of a takeover as involving determination whether an anti-takeover measure is reasonable in relation to the threat imposed.
63. Anti-takeover measures implemented by a board as involving a good faith and reasonable investigation to determine the existence of a danger to the corporation's policy and effectiveness.
64. Expenditure of corporate funds in proxy contests as subject to director's duties in loyalty, care and diligence.
65. Merger of the corporation as involving directors' duties of care and loyalty to the corporation and its shareholders.
66. Offerors of competing acquisition offers as being entitled to equal treatment.
67. Purchase of shares by corporation primarily to retain management in control.
68. Rejecting of acquisition offer and refusal to submit it to shareholders.
69. Sale of a controlling interest as involving duty of loyalty and requiring awareness of buyer's intentions as to looting corporation.
70. Takeover bids and related matters as involving directors' duties of care, loyalty and diligence to corporation and shareholders.
71. Takeover threats causing reality of a break-up of the corporation, resulting in duty of directors to obtain highest stock price for benefit of shareholders.

## Other Matters Involving Shares and Shareholders

72. Annual reports.
73. Beneficial ownership of shares, application of Section (16)b of Securities Exchange Act.
74. Control person's vicarious liability.
75. Deceptive representations.
76. Delivery of securities promptly after sale.
77. Disclosures insufficiently or improperly made.
78. Discrimination against minority shareholders.
79. Fraudulent conduct in connection with purchase or sale of securities.
80. Fraudulent methods, misstatements or omissions relating to material facts.
81. Fraudulent reports, financial statements of certificates.
82. Freeze-out mergers without business purpose.
83. Insider making short sales.
84. Insider trading without disclosure of non-public information.
85. Interstate use of mails in sale of unregistered securities.
86. Material misstatements in filings, registration statements or reports to agencies.
87. Misuse of insider information.
88. Prospectus and communications with investors.
89. Proxy context filings.
90. Proxy statements.
91. Reports to SEC and state agencies.
92. SEC filings.
93. Short swing profits in stock trading.
94. Tipping by insiders.
95. Conflicts of interest.
96. Earnings forecasts.
97. Extent of board participation in improper actions.
98. Illegal payments.
99. Material facts.
100. Political contributions.
101. Pre-tax income
102. Publicizing information as to favorable or unfavorable transactions or occurrences.
103. Sales information.
104. Sufficiency of disclosures
105. Surplus earnings.

106. Timeliness of disclosures.

## **Matters Involving Taxes**

107. Causing corporation to incur unnecessary tax liability or penalty.  
108. Failing to monitor filing of tax returns and payment of taxes.  
109. Failure to obey requirements of tax laws and regulations.  
110. Failure to require withholding in connection with Social Security or income taxes.  
111. Failure to secure funds withheld for Social Security or income taxes.

## **Miscellaneous Matters**

113. Aiding and abetting actions of others.  
114. Carelessness in concluding business or legal matters.  
115. Commercial bribery not disclosed.  
116. Consenting to improper or illegal actions resulting in losses.  
117. Detecting and preventing embezzlement of corporate funds.  
118. Failing to see what could be seen by merely looking.  
119. Federal Election Campaign Act.  
120. Federal Corrupt Practices Act of 1977.  
121. Fraudulent interstate transactions.  
122. Inducing corporation to commit breach of contract.  
123. Inducing intentional or careless wrongdoing by corporation.  
124. Ignoring statutory or regulatory requirements.  
125. Insufficient monitoring or supervision of officers or other employees.  
126. Non-disclosure of questionable or unlawful actions.  
127. Racketeering activity.  
128. Treble damages or civil fines for statutory violations.  
129. Use of mails, wire services, telephones, radio or television to defraud.  
130. Wasting corporate assets.  
131. Willful wrongdoing.

*Source: William E. Knepper and Ann Bailey, Liability of Corporate Officers and Directors (4<sup>th</sup> Edition)*