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DIRECTORS AND OFFICERS INSURANCE FOR PRIVATE COMPANIES IS A SOUND BUSINESS DECISION

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The trend toward obtaining directors and officers insurance (“D&O insurance”) for private company officers is becoming more apparent. The well-publicized Enron and WorldCom cases underscore the potential for exposure to directors and officers of private employers resulting from claims of alleged wrongdoing.

D&O insurance covers claims that arise from alleged wrongdoing by directors and officers in their corporate capacities. Such claims usually involve the officers and directors investment decisions, such as allegations that placement materials were misleading, that management failed to perform, acted in self interest or made decisions detrimental to the company. D&O claims may also involve decisions to raise capital, expenditure of such capital, and decisions to merge into or acquire other companies.

Employees may also bring claims against directors and officers. Such claims typically include wrongful termination, employment discrimination based upon a protected class (race, religion, age, gender, national origin, pregnancy, sexual orientation and disability), harassment, retaliation (whistleblower), and breach of employment contract.

Settling claims against directors and officers has proven costly. For example, the amount of the Enron settlement is approximately \$7.7 billion to date, with WorldCom close behind at \$7.0 billion. Other notable settlements include AOL Time Warner at \$2.4 billion; Ahold at \$1.1 billion; and McKesson at \$960 million. Although class action securities fraud filings reduced in 2005 to 176, which is 10% below the 1996-2004 average of 195, individual claims settlement costs continue to increase with “major” losses now being classified as those exceeding \$300 million compared to the previous \$25 million.

Although the settlement figures above involve publicly traded companies, directors and officers of private companies can also be sued by shareholders and employees and they can be held personally liable for the decisions they

make. Indeed, managers of privately held companies are particularly vulnerable to being sued because of their typical close involvement in the company's day-to-day operations and because such companies often lack the resources to comply with the myriad of compliance laws involving investment, employment, and other claims.

In fact, a recent New York decision held that the directors and officers of a privately held company had the same fiduciary duties as would those serving a public company. In that case, creditors targeted corporate officers and directors claiming breach of their fiduciary duties to keep the struggling company solvent. The directors and officers were held liable, even though they did not benefit from the company's bankruptcy filing in any way.

The personal assets of a director or officer of a private company may be at risk if the company cannot indemnify its directors or officers either because of the particular allegations of a lawsuit, or because the company becomes insolvent. Further, due to the limited assets of most private companies, directors and officers of private companies may face even greater exposure than their public counterparts. Where insurance is found to be inadequate, shareholders are increasingly seeking contribution from the individual directors and officers, such as in the cases of Enron and WorldCom.

There has been a recent shift in director and officer liability jurisprudence in favor of the investor-plaintiff. For example, while the "good faith" legal defense remains strong for directors (note the Disney case in Delaware), the "business judgment rule" has been eroded in recent court decisions that increasingly second-guess the decisions of company leaders. Furthermore, although the Sarbanes-Oxley Act generally applies only to public companies, it is now being used as the "standard of care" against private companies, resulting in an increase in the standards of corporate governance and the expectations of management of private companies.

D&O insurance is an appropriate and sound business decision for private companies, and at the least, prudent management should consider the costs and benefits of obtaining it.

