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Does a Private Company need D&O Insurance?

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Public companies routinely purchase directors and officers (“D&O”) liability insurance, and regard the purchase as part of the cost of being a public company. But does a private company need D&O insurance?

Like public company directors and officers, private company Ds and Os face the potential prospect of unlimited personal liability. Nevertheless, the private company D&O litigation environment is very different from the public environment. Private company directors and officers are statistically unlikely to be sued, especially compared to their public company counter-parts. Moreover, when private company directors and officers are sued, the settlements are usually smaller than for public company litigation. As a result, private company D&O insurance is significantly less expensive than public company D&O insurance.

No matter how low the cost, however, there are times when private company D&O insurance is a comparatively unnecessary purchase. For example, early stage companies in which all the shareholders are active founders and there are few to no non-founder employees are better served by spending their insurance dollars elsewhere.

Private companies without these “simpler” characteristics, however, often purchase D&O coverage for one or more of the following ten reasons:

1. **Bankruptcy.** Private companies sometimes go bankrupt. In bankruptcy, creditors sometimes sue directors and officers. When a corporation is insolvent, only D&O insurance stands between these creditor suits and the personal assets of the directors and officers.
2. **Regulatory Exposures.** Private companies are subject to government regulation as well as government enforcement of regulations. The United States’ Department of Justice’s vigorous enforcement of the Foreign Corrupt Practices Act is a good example of government enforcement against private companies. Paying the cost of an attorney to defend an officer (or director) against a government enforcement action is an expensive proposition. Some D&O insurance policies can help with these types of expenses.
3. **Shareholder Suits.** Private companies can be the subject of shareholder suits. As the number of shareholders (without board representation) grows, the risk that a disgruntled shareholder might bring suit against a company’s directors and officers grows. This is especially the case if a company has to do a “down round” of financing. It can also be an issue in an M&A environment, even when the price for the company is a good one. D&O policies can be especially helpful in funding the litigation defense costs of directors and officers who are accused of failing to obtain a high enough sales price for a company.
4. **“Warranty” Obligation.** Any company purchasing a new layer of D&O insurance, be it the company’s first million dollars of coverage or a new excess layer, must make a warranty to the insurance carrier(s) to the effect that the company knows of nothing that is likely to give rise to a claim under the “new” layer(s). As a company matures, events can unfold that make such a warranty statement harder to make. For this reason, companies sometimes buy D&O insurance sooner rather than later.
5. **IPO Considerations.** A company that is considering going public might purchase D&O insurance while still private. The often stated reason is to build a relationship with public company insurers. This is nice to do, but certainly not necessary in the current, highly competitive market for IPO D&O insurance. As referenced above, a serious reason that a pre-IPO company might buy D&O insurance, however, is to avoid having to make any warranty statement for at least the first layer of insurance on which the company intends to rely after it goes public.

Not having a warranty statement makes the insurance more secure in its ability to protect directors and officers because the carrier will not be able to assert a warranty statement problem to avoid covering the claim.

6. **New Directors.** Private companies that want to attract new independent board members can use the purchase of D&O insurance to make the board seat that much more attractive. Having a good D&O insurance program in place also helps to convey that the private company is being managed and operated in a way that resembles a serious public company.
7. **Mergers & Acquisitions.** A company that may pursue M&A as an exit strategy or liquidity event may be a company that should purchase D&O insurance sooner than later. Current directors and officers will want to be indemnified in the case that they are sued after the deal closes; however, an acquiring company may not be willing to do this. Moreover, even if the acquiring company is willing to provide this indemnification, the promise to indemnify will be meaningless if the acquiring company eventually goes bankrupt itself. D&O insurance can solve this problem—and the problem is most easily addressed when there is already a D&O insurance program in place.
8. **Venture Capital Requirements.** Some venture capital firms require that their portfolio companies purchase D&O insurance as a condition of the venture capital firm's investment.
9. **EPL Coverage "Discount".** Private companies can bundle the purchase of D&O insurance with other, related lines of insurance such as employment practices liability insurance ("EPLI"). Since the bulk of the insurance premium is often related to the EPLI part of the policy (employment related suits being a higher risk than D&O claims), the D&O insurance that can be included in the policy is often seen as an economical way to shift risk away from the company and its directors and officers.

10. **Emerging Risks.** The legal landscape can change abruptly and rapidly. Private company D&O insurance may be able to respond to newly emerging risks. For example, a few years ago, it would be rare to hear anyone cite the need to defend against possible illegal insider trading allegations as a reason to purchase private company D&O insurance. With the recent emergence of secondary sales platforms for private company stock, however, this is changing.

Of course companies change over time, so the assessment of whether or not a company should purchase D&O insurance should be regularly revisited as part of a company's overall insurance risk review and assessment process.

Questions? Comments? Concerns? Please contact your Woodruff-Sawyer representative or Priya Cherian Huskins (phuskins@wsandco.com or 415.254.3524).

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