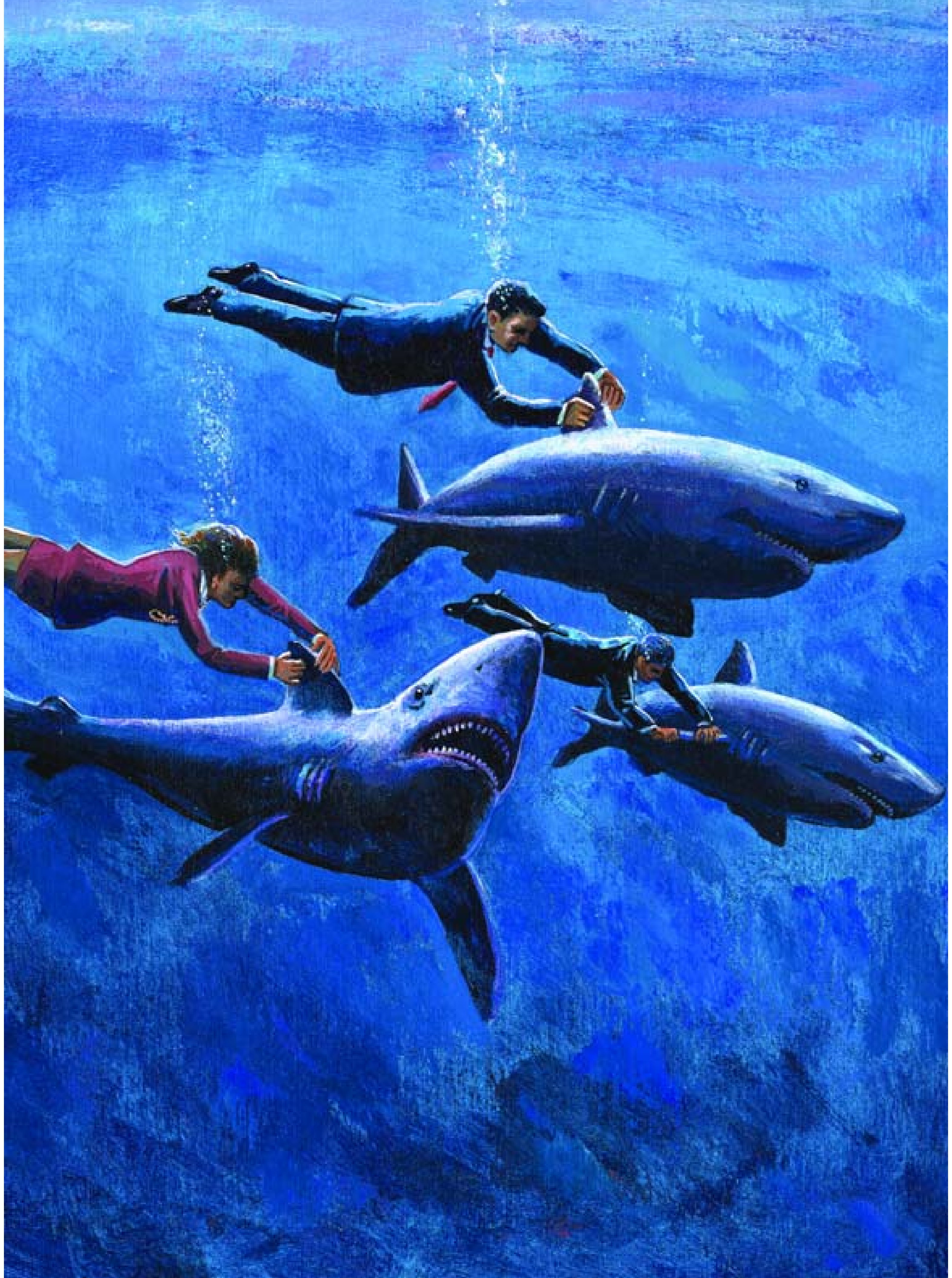

Taming risk with management liability insurance

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THERE IS often a misconception among directors and offices of privately held companies that they are somewhat insulated from D&O litigation because they are not as visible as their counterparts in publicly-owned companies are. But based on recent surveys and court decisions, the likelihood of a director or officer of a privately held corporation being sued have increased substantially. Widespread media coverage of employment-related litigation, increased merger and acquisition activity, a still uncertain economy and regulators' enhanced scrutiny are among the reasons for the heightened exposures directors and officers face.

The most important reason for directors and officers of private corporations to buy D&O liability insurance is to protect their own assets, since they can be held personally liable for their wrongful acts committed on behalf of the corporation. In most instances, a corporation is obligated to indemnify its directors and officers for costs associated with such litigation, subject to a few but important exceptions. When determining a corporation's responsibility to indemnify, one must review the company's bylaws and the state's indemnification statute.

A company's financial ability to indemnify should also be considered. A rash of bankruptcy filings over the last three years—some high-profile in nature—has led to conflicting decisions concerning who has jurisdiction of a bankrupt corporation's assets and has raised questions about indemnification of directors and officers in such cases. Unfortunately, it could be years before the courts hammer out a final position on this issue.

What to look for in products that protect executives of privately held companies.

One common exception to a corporation's obligation to indemnify its directors and officers is when doing so would be against public policy. A corporation cannot indemnify its executives from derivative litigation because of its nature (shareholders seeking recovery on behalf of the corporation itself). Usually litigation involving allegations of fraud cannot be indemnified because of states' "good faith" indemnification provisions. In all of these instances, directors and officers are left to fend for themselves, and without separate coverage may have to use their personal assets to defend and settle the litigation.

Directors and officers of privately held corporations, like those of publicly owned businesses, have a duty of care and loyalty. Directors and officers must always put the interests of their corporations, the shareholders and employees first. Often litigation arises because a claimant alleges there has been a breach of this fiduciary duty.

This was well illustrated in June 2003, when a federal District Court in Manhattan handed down a ruling against Marshall S. Cogan, an affluent art collector and former owner of the famous New York restaurant, the "21" Club. Mr. Cogan, was found guilty of draining Trace Holdings, his now bankrupt international personal holding company, of tens of millions of dollars while giving himself a lavish lifestyle and providing loans to others, which he arranged without regard to his fiduciary responsibility to the company. Not only did the judge find Mr. Cogan liable but also held the company's other directors and officers culpable, even though they were not involved in the wrongful acts. The judge felt they did little or nothing to stop Mr. Cogan, despite their own fiduciary duty to the corporation. While one might think this is an extreme case, it is now part of case law and has set a new standard for the fiduciary duty owed by executives of privately held companies—no matter what their size.

Directors and officers of privately held companies can face a variety of allegations from competitors, customers, regulators, shareholders and employees. Claims of unfair business practices, antitrust, unfair competition, deceptive trade practices, breach of fiduciary duty, conflict of interest, corporate mismanagement, misappropriation, fraud, misrepresentation, securities fraud, discrimination and capital-raising-activity misrepresentation, among other allegations, are not uncommon. A recent survey concluded that one of three mergers or acquisitions also results in litigation.

Employment practices claims are by far the type most commonly filed against directors and officers of privately held businesses. Many damage awards are setting precedents, and settlement amounts are rapidly growing.

Directors and officers of closely held companies need to be concerned about the effects of litigation. On its own, a closely held corporation may not have the resources to pay for a protracted defense, let alone a judgment. Management liability insurance policies can provide invaluable protection for these corporations and their executives. These claims-made policies have been designed specifically for privately held corporations. Such a policy provides both D&O and employment practices liability insurance. Fiduciary liability coverage to protect the trustee of any pension or profit-sharing plan can be included, as well as crime, kidnap/ransom and Internet insurance in some cases. The definition of insured usually includes directors, officers, employees and the entity.

Not all management liability insurance contracts are the same. Each insurance company offering the product has its own policy. Agents and brokers should make a comprehensive review of available products to determine which offers the broadest coverage and best value for a given client.

When determining how much protection to buy, there are two options to consider. Traditionally the only option was one aggregate limit for all coverages in the policy. Thus a catastrophic EPLI claim would substantially diminish the remaining protection for a D&O, fiduciary or other claim. In the last few years, some underwriters have begun to offer separate limits of liability for each coverage. While such products are more expensive than single-aggregate policies, they provide greater protection to directors, officers and the company itself.

D&O policies designed for public companies provide entity coverage only if the entity is a co-defendant with a director or officer in a securities claim. Management liability policies, on the other hand, cover entities as codefendants in any type of claim (subject to the policy's terms and conditions). This avoids the "allocation" issue that arises with most monoline D&O policies. Entity coverage is particularly important in EPLI claims, which almost always name the company as well as directors, officers, managers and supervisors.

Management liability insurance often provides prior-acts coverage. The policy also contains a section referring to statements and representations made in the application.

A submission requires a completed application, the company's latest financial statements, an employee handbook and, for companies less than three years old, a business plan. A completed application becomes part of the policy and is materially relied on by the underwriter. The application includes a number of warranty statements that, if breached by the insured, could affect the claims settlement. Application forms and warranty questions differ widely from one company to another. They should be carefully considered when evaluating proposals from multiple underwriters.

To broaden coverage, many underwriters offer a "severability" extension. Simply stated, severability protects those who do not sign the application should warranty issues arise. This can become important in the event of a claim arising from an incident of which the insurer believes the app's signer had prior knowledge. (Such claims are excluded by one of the warranty statements.)

Management liability policies may be written to provide "duty-to-defend" or "non-duty-to-defend" coverage. Under the former, the insurer will select defense counsel in the event of a claim. Under the latter, the insured is responsible for selecting counsel. The insurer retains the right to approve the insured's choice, but consent cannot be unreasonably withheld. One drawback to the "non-duty-to-defend" option is that the insured bears the cost of defense from the outset of a claim until it is reimbursed by the insurer. Some policies advance defense payments to limit the drain on the insured's working capital.

Most management liability contracts have "pay on behalf of" as opposed to "reimbursement" wording. With the latter, an insured temporarily could incur substantial out-of-pocket costs.

Worldwide coverage is desirable, since many large, privately held companies have foreign operations. Depending on the state of the insurance market, other enhancements available may include third-party discrimination coverage, defense costs in addition to the liability limit and a modified settlement ("hammer") clause.

When evaluating management liability markets, consider the carriers' expertise, seasoning and commitment to the product; the quality of their underwriting; their dependence on reinsurers; and their willingness to compromise if there is a difficult situation.

Consider an insurer's claims-settlement reputation and practices. Two issues in particular should be investigated: the insurer's demonstrated interest in equitable solutions and its willingness to continue coverage after claims. Some carriers offer aggressive terms and pricing but will sever the relationship once a claim is submitted. Being "nonrenewed" by an underwriter creates a number of problems.

Privately held companies thinking of going public within three to four years should choose their management liability insurer carefully. By discussing this issue in advance with underwriters, agents and brokers can improve the odds that their clients will not have to change insurers when they alter their ownership status. Freed of the necessity to find another carrier, producers and their clients can focus on switching to D&O and EPLI coverage from management liability insurance. By staying with the same carrier, an insured also may not have to sign another warranty statement, which could create new exposures.

While many insurers have slowed their pace of D&O writings for publicly held companies, there has been an influx of capacity for management liability insurance, which has lowered pricing to mid-1990 levels. Many insurance companies have separated EPLI and management liability underwriters, creating internal competition for business, which can work in an insured's favor.

Offering comprehensive management liability insurance to the privately held businesses among your clientele gives you the opportunity to be proactive and to address two of the fastest growing perils directors and officers face (D&O and EPLI). It should be standard operating procedure for all agents and brokers active in commercial lines.