The liability exposures of private company directors and officers:
Are the executives of your organization protected?
Protecting private company directors and officers from claims arising from mergers & acquisitions, IPOs and bankruptcy.

Directors and officers of private companies share many of the same management liability exposures, and are held to the same standards, as their public company counterparts. In fact, courts have held that directors and officers of private companies must adhere to the same fiduciary duties as public company directors and officers. Additionally, the ownership structure of private companies exposes their directors and officers to risks not typically associated with public companies. Lawsuits can be brought by minority shareholders, employees, creditors, business partners or regulators.

The recent recession and the current recovery highlight three sources of risk that may be faced by private company directors and officers: mergers and acquisitions (M&A’s), initial public offerings (IPOs) and bankruptcies. Both M&A activity and IPOs increase following a recession, and frequently are the source of litigation. Bankruptcies skyrocket during a recession, and continue at an elevated pace in the early stages of a recovery. Bankruptcies are particularly dangerous to directors and officers since the bankrupt company may not be able to indemnify them for defense costs or settlements if they are sued.

Directors and officers can take common sense steps to help reduce the likelihood of a lawsuit, but no amount of care can guarantee they will not be sued. Since these suits can put the personal assets of directors and officers at risk, directors and officers liability (D&O) insurance is essential. Over the years, insurance companies have developed policies specifically tailored to the unique exposures faced by private companies and their directors and officers.

Mergers and acquisitions

After experiencing sharp decreases in 2008 and 2009, M&A activity picked up in 2010 and is expected to grow at an even faster pace in 2011. With mergers and acquisitions comes a heightened probability of a lawsuit naming the directors or officers of the acquired company.

So-called merger objection suits are skyrocketing. These suits often allege that directors of a company were not looking out for the best interests of shareholders when they agreed to the terms of a transaction. According to a recent study, the number of merger objection suits filed in the United States rose from 18 in 2003 to 334 in 2010, growing rapidly even as the number of transactions plummeted during the recession years.
While suits arising out of M&A activity are more common for public companies, shareholder suits are also a concern for private company directors and officers. In these situations, minority shareholders of the private entity, many times employees, typically claim that majority shareholders/board members pursued a deal that benefited them at the expense of minority shareholders.

In one representative example, a former executive and shareholder of Lillibridge Health Services Inc. filed a suit alleging that two other senior executives of the medical office building developer received $14.7 million in “excessive and improper payments” in the company’s 2010 sale to a healthcare real estate investment trust. According to the complaint, the CEO and the Chief Financial Officer demanded “excess parachute payments” to agree to the deal. Lillibridge’s majority shareholder, Prudential Real Estate Investors Inc., allegedly worked out side agreements “to obtain their cooperation.” “The resulting $14.7 million diversion of the proceeds (to the two executives) was approved at the expense of the fair value due to” minority shareholders, according to the suit.

Merger-related suits involving private companies typically are filed by minority shareholders, but there can be other classes of plaintiffs. One scenario is a business partner who claims to have been damaged because of a merger, and sues for, perhaps, breach of contract or tortuous interference. Also, some mergers, especially “reverse mergers” in which a private company buys a public company shell with which to merge, have Securities and Exchange Commission disclosure requirements that could trip up unwary private company directors and officers.

Initial public offering
Initial public offerings (IPOs) are surging as the economy continues its recovery. There have been more IPOs so far in 2011 than in 2008, 2009 and 2010 combined 3.

The most significant IPO-related exposure to private company directors and officers is from disclosures (or lack thereof) to potential investors in registration materials and solicitation documents, or in a “roadshow” where senior managers make representations about the company to potential investors and analysts. Lawsuits typically are brought after the company fails to perform up to expectations; shareholders may claim that management did not disclose critical, material information.

GT Solar International, a manufacturer of materials for the solar power industry, completed its half-billion dollar IPO on July 23, 2008. Nine days later, the first of a series of lawsuits was filed, alleging that the registration statement failed to disclose the true extent of the risks surrounding the company’s relationship with LDK Solar, which represented 62 percent of GT Solar’s revenue in 2008. A day after GT Solar launched its IPO, LDK signed a contract to purchase production equipment from one of GT Solar’s competitors. In March of 2011, GT Solar reached a $10.5 million agreement in two of the suits, of which $9.5 million is covered by the company’s D&O insurers 4.

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While most IPO-related suits rely on statements made in registration materials and solicitation documents, some suits are based on statements made in investor roadshows. A critical part of any IPO is the road show, when the management of a company meets with potential investors and analysts, providing information on the upcoming offering. After the IPO, shareholders may allege they relied on misstatements by management made during a roadshow presentation.

Bankruptcy-related suits

Business bankruptcy filings slowed a bit in 2010, but were nonetheless more than double the number of filings in 2006 and 2007. Though the economy now is slowly recovering, 2011 is expected to be another above average year.

Bankruptcies inevitably call into question the decisions and actions of directors and officers. Shareholders or other stakeholders may sue, claiming that directors and officers were negligent in their actions or acted in their own interests and not in the interest they owed others. Bankruptcy trustees may attempt to recoup losses. Even the bankrupt company, as debtor in possession, may sue its own directors and officers, claiming breach of fiduciary duties.

Fortunately for defendants, courts often give deference to decisions made by directors and officers under the ‘business judgment rule’, which gives directors and officers the presumption that they acted with good judgment and good faith in their business decisions, including decisions that may have resulted in bankruptcy.

A recent example of the application of the business judgment rule is *Bridgeport Holdings Inc. Liquidating Trust v. Boyer*. In this case, the liquidating trust sued the former directors and officers alleging they failed to pursue all viable options before filing for bankruptcy. In finding for the defendants, the court found the directors and officers acted in good faith and were entitled to the protections of the business judgment rule.

Even if defendants prevail, however, lawsuits can result in hundreds of thousands of dollars in defense costs. In one case, shareholders sued the directors of a bankrupt corporation, alleging that the directors mismanaged the business causing it to fail. The action was discontinued, but defense costs totaled $170,000.

Directors and officers may find their personal assets are at risk if the bankrupt company is unable to indemnify them for their legal fees, and recoveries under the company’s D&O policy are determined to be assets of the bankruptcy estate. In response to this situation, insurers now offer so-called Side A D&O insurance. A Side A policy, which insures only the directors and officers and not the company itself, provides protection if the company is unable to indemnify its directors and officers for defense costs or settlements. Even if the company enters bankruptcy and a court freezes the standard D&O policy as an asset of the bankruptcy estate, Side A coverage will indemnify the directors and officers.
Conclusion

The recession, and now the economic recovery, have changed the risk landscape for private company directors and officers. Bankruptcies rose sharply during the recession, and the risk remains heightened in the early stages of the recovery. Thawed credit markets and generally improved business conditions are leading to an increase in M&As and IPOs. With these increases comes heightened risk for directors and officers.

Private company directors and officers need to recognize their fiduciary duties to the company and its minority shareholders, and to act appropriately. But even the most diligent directors and officers are sometimes sued. As a result, D&O insurance is essential. Traditional ABC D&O insurance provides coverage to both the company and its directors and officers, and is an essential part of any risk management program. Companies also should consider purchasing Side A coverage for its directors and officers. Side A insurance will protect directors and officers in the event of a bankruptcy or if it is determined that a company cannot indemnify its directors and officers as a matter of public policy. Additionally, Side A insurance usually provides broader coverage than the typical ABC D&O policy.

Why Zurich?

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Zurich’s Side A coverage is also available for instances where a company cannot indemnify its directors and officers for lawsuit expenses and settlements and, for any of a variety of reasons, coverage is not available under traditional D&O policies.

Zurich’s integrated claims model offers a dedicated and single point-of-contact for all our D&O customers during the claims process – helping to respond to their unique needs. Plus, our robust international platform enables us to address an insured’s stateside exposure and international footprint in 180 countries and territories.

For more information on Zurich’s Private Company Select insurance policy:
• visit us on the web at www.zurichna.com/zna/directorsandofficers/middlemarket.htm
• reach out to your regional Zurich representative,
• or call us at 866-860-7292

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