

Private and Protected

Private company executives are vulnerable to professional liability exposures and risk to their personal assets

Even without a stock symbol or the limelight that being on the New York Stock Exchange or NASDAQ may bring, private companies have many of the same professional liability worries as publicly-traded firms.

While most private companies and their executive liability claims may make fewer news headlines, private companies operate alongside public companies in the same litigious society where both find themselves under increased government scrutiny. Accordingly, many more privately held businesses and their executives are choosing not to overlook their potential professional liability exposures.

As one recent study conducted by Towers Perrin points out, more public and private companies — 66% of the survey’s nearly 2,900 respondents — have received a record number of inquiries from potential board members who are concerned about their current directors and officers (D&O) liability insurance. The survey found a 16% increase from the previous year. At the same time, the survey shows that companies are responding to these inquiries by providing broader personal liability protection for directors and officers. According to Towers Perrin, in the past year 14% of those surveyed purchased Side A-only coverage, offering directors more personal liability protection when they are not indemnified by the company.

ONLY HUMAN

Executives are only human. And as the saying goes, “To err is human, to forgive divine.” However, in today’s somewhat shaky economy and in the wake of history-making corporate misconduct, shareholders are less forgiving. They often want to see some accountability and as many directors and officers have learned, they may risk personal assets in living up to their accountability.

When the stock price takes a dive, a business deal goes sour, or there is general unhappiness with the way things are being run, D&O coverage has become an insurance portfolio necessity to address executives’ potential exposures. Private corporations have shareholders, too — business partners or investors who may have millions of dollars at risk — and who may be concerned with company activities.

Courts have held both management and the company responsible for wrongful acts of subordinates and for negligent supervision, improper screening of employees, and failing to investigate or respond to employment-related violations.

In one recent case, two former co-founders of a small company brought suit, on behalf of common shareholders,

against the third co-founder and current CEO. They also included in the suit the company’s board of directors whose membership included venture capital representatives. The suit alleged that the board and current CEO engaged in an unlawful scheme to dilute or “smash down” their ownership interests by issuing additional stock that allowed the defendants to “squeeze out” the plaintiffs to maximize their own corporate control. The defendants argued that the issuance of the stock was necessary in order to attract funding and keep the company from becoming insolvent. Like many executive liability-related lawsuits, the suit never went further than the initial pleading stage and was settled. In the end, the company’s D&O insurance carrier contributed \$850,000 to the final settlement and paid over \$200,000 in defense costs.

WRONGFUL ACTS

Courts have held both management and the company responsible for wrongful acts of subordinates and for negligent supervision, improper screening of employees, and failing to investigate or respond to employment-related violations. In one case, a company was presented with demands by a neighbor who claimed to have suffered a large property loss after a flood. The flood was said to have been caused by the company’s failure to maintain a bridge. The lack of maintenance resulted in debris collecting and backing up water, flooding the neighbor’s land. The company contacted their General Liability carrier to cover this loss but after inquiry it was determined that the neighbor warned one of the company’s directors of potential

flooding and the director failed to act upon this information. In this case, the projected settlement including defense expenses likely will be in the range of \$250,000 to \$500,000.

Aside from shareholders, private companies are also susceptible to claims from lenders and creditors, customers/clients, and regulatory agencies. Consider the situation in which a client of a software company sued the company for breach of contract. The client later amended its complaint to include the company's CEO for claims of fraudulent inducement in the making of the contract and fraudulent transfer of assets. The client alleged the company failed to meet the implementation deadline for time-critical software despite repeated assurances that the system would be operational by the due date. The client claimed damages to be more than \$400,000. Fortunately for the CEO, the software company's D&O carrier provided defense expenses, estimated to be over \$500,000, for the CEO. The matter was settled for \$200,000, with \$175,000 of the settlement paid from the company's D&O coverage.

WORKFORCE WORRIES

Among both public and private companies, the greatest concern for potential management liability emerges from their employees. Employment-practices related litigation (EPL) now represents over 25% of all lawsuits against directors and officers. For many rapid-growth companies, the probability of litigation can increase because strong human resources practices and procedures are not yet in place. Other areas of litigation may arise when



key technical employees move between competitors. This type of litigation frequently names the directors or officers in the recruitment of the individual and in soliciting trade secrets. Today, D&O policies are structured to provide protection against the exposures that private companies face.

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Nearly 80,000 employment practices claims were filed with the Equal Employment Opportunity Commission (EEOC) in 2007. Monetary damages in these cases topped \$200 million — compared with \$169 million in 1998. Cases of racial harassment filed with the EEOC increased 24% last year. The number of racial harassment filings at the Commission increased from 5,646 in 2006

to 6,977 in 2007. The annual figure has more than doubled since 1991.

The most common charges filed with the EEOC in 1999 were racial discrimination (37.3%), sex discrimination (30.9%), retaliation (25.4%), disability discrimination (22.4%), and age discrimination (18.3%). While some 85% of all employment practices cases are settled usually for undisclosed amounts, employee liability claims are costly. The number of employment practices claims filed against directors and officers has doubled in recent years.

Unquestionably, private companies share many of the same executive liability concerns as public companies. While they are free of stock market concerns and public spotlight, private companies, no matter how “closely-held” they may be, cannot afford to be oblivious to the D&O liability perils.



(Pictured, left to right) Robert Martin, Underwriter, Professional Liability; Katie Duff, Underwriter, Professional Liability; Katie Fogarty, Underwriter, Professional Liability; Paul Dube