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D&O INSURANCE FOR PRIVATELY-HELD COMPANIES, PRIVATE EQUITY AND NON-PROFITS

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MINI-ROUNDTABLE

D&O INSURANCE FOR PRIVATELY-HELD COMPANIES, PRIVATE EQUITY AND NON-PROFITS

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Pam Mason leads Mason & Mason's Innovation Practice, specialising in corporate securities liability, directors and officers liability, private equity and venture capital liability, ERISA fiduciary liability, employment practices liability, M&A representations and warranty insurance. Ms Mason's strong technical understanding of the insurance products that facilitate risk transfer allows her to focus on working with clients on risk assessment. She also has extensive experience with complex litigation, including securities fraud and other shareholder rights matters, bankruptcy matters, M&A indemnity claims, and employment actions.

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James Geshwiler joined CommonAngels in 1999 and has been an active investor in mobile, cloud, consumer and business software as well as digital media companies. He also has been a leader in shaping the institutionalisation of angel investing. He was the founding chairman of the Angel Capital Association, as well as sister organisation, the Angel Capital Education Foundation. He is on the board of trustees of the Massachusetts Technology Leadership Council and the board of the MIT Alumni Association. He has written papers and articles on angel investment processes, and regularly speaks on entrepreneurship and private investing.

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Carl Metzger is a partner in Goodwin Procter's Business Litigation Group and leads the firm's Risk Management & Insurance practice. His clients include both public and private companies, private equity and venture capital firms, and non-profit and educational institutions. He is recognised as an expert in advising boards of directors and senior officers on liability and risk management issues, as well as D&O insurance, indemnification and fiduciary duty issues. His experience includes securities litigation defence, financial fraud litigation, governmental and self-regulatory organisation investigations, and complex business disputes.

RC: How would you describe current levels of awareness around D&O liability? Is there a lack of clarity on potential risks – and how to manage them with insurance solutions?

Mason: Overall, I think there is a high level of awareness surrounding liabilities of directors and officers. Individuals sitting on boards, particularly outside or independent directors, are concerned about protecting their personal assets in the event they are sued. This is a uniform concern among all companies – private, public and not for profit. Similarly, businesses view D&O coverage as a means to protect their balance sheets in situations where they have to expend monies to indemnify their directors and officers, or in situations where claims are made against the corporate entity itself. But as concerned as individuals may be about protecting their own liabilities, there are still firms that forego purchasing D&O coverage, especially closely held companies, as they cannot envision a scenario where they would be sued. Other companies hastily purchase coverage without really understanding whether the D&O insurance policy is comprehensive enough to protect them in the event of a claim. Each of these strategies can be problematic. D&O litigation is complex and there are ample sources of claimants outside of a shareholder. In a general sense, the D&O market has softened for private and not for profit businesses in the past few years, to the extent that most policies have decent baseline coverage. However, D&O insurance is not standardised, so there remain vast differences between what one insurer will offer over another. Even small sized risks need attention to detail when it comes to coverage. At the end of the day, litigation is litigation.

Geshwiler: From a general perspective, there is awareness of the major issues associated with the liability of directors and officers. But with awareness comes a greater appreciation that liability itself is further complicated due to changes in case law, claims and the coverage structure of policies. As investors, our focus is on dealing with young companies, ranging from true start-up to those with tens of millions of dollars in revenue. In this effort, our main job and core competency is to concentrate on the upside. If we take our eyes off of that task, for even a few minutes, we might miss out. Though we don't have the luxury of a lot of time in which to keep current and becoming experts on these liability issues, should we fail to spend some time considering the management of risks, it can compromise the upside. The key is that D&O insurance can relieve direct tension of day to day operations.

Metzger: Awareness levels largely centre around two groups. One is out of necessity of a term sheet requirement where management is obligated to

effect D&O coverage in order to satisfy a contractual requirements to its investors. The other centres on astute business people who truly understand the importance of D&O coverage as a means of protecting their personal assets, as well as the balance sheet of the company. The former group typically represents a 'procedural' mindset of a younger company, whereas the latter considers D&O insurance to be a strategic business decision. Though knowledge and understanding of D&O insurance is better than it used to be, there is still room for improvement. Indeed, companies' understanding arguably could and should be better than it is today. We still see private companies that either don't have enough D&O insurance or the coverage they do have is inferior with regard to the competitiveness of its policy terms. What's interesting about the current marketplace is that private company D&O is not particularly expensive and forms are about as wholesome and broad as they have ever been in history of the market. So, it is a terrific time to be a buyer of D&O insurance, for comparably little money you can get a very strong private company D&O policy in place with sufficient limit. A D&O policy is a critical firewall of protection for directors and officers in terms of personal liability. You don't want to wait so long that your company is behind the curve in terms of protection for its D&Os. If anything, companies should be conservative and ensure that people are well protected with adequate personal liability protection. There is no excuse for being under-insured in light of how competitive the pricing is these days.

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> *James Geshwiler, CommonAngels Ventures*

RC: What is driving D&Os of privately-held companies, private equity firms and non-profits to take out D&O liability insurance? To what extent are their personal risks increasing?

Geshwiler: As it relates to the factors driving the decision to purchase D&O coverage, motivations will vary by type of individual. For independent directors and high net worth individuals, or angels, their personal liability is at the top of the list. They

are taking on a project and putting large amounts of their own net worth into a company, but by definition as accredited investors, it is likely a small portion of their total net worth. In the context of an unstable company where they have a small amount of invested assets, the liability exposure can be disproportionate. Personal coverage is always at the forefront of their conversation. These companies are thin on their own assets, and may not be able to indemnify these individuals. For people who manage funds, the dynamic is different as they have fund capital that will also indemnify them, but their focus is much more on obtaining upside of their investment. These individuals are measured by performance and their careers depend on their ability to go back to the market, show their performance and raise another fund. If they get distracted by getting stuck in the mire of a lawsuit, it can impair their ability to pursue upside and raise the next fund. Attention to detail is usually a bit higher on the institutional side, but many do not want to be bothered with the details. They just want to make sure coverage is well considered.

Metzger: Contractual requirements largely account for any company to buy D&O insurance, whether from term sheet requirements of investors or requests from limited partners. The good news is that there are relatively few instances where D&Os end up personally liable for a judgement against them in their capacity as a director or officer of a company. The bad news is that in our business litigation climate, it's often the case that individual D&Os are named as additional defendants in cases that really should just be against the company. Accordingly, in the long term, we are likely to see a gradual increase in the number of cases that could result in personal liability for D&Os. It's a problem likely to get worse, not better, relative to personal liability for D&Os.

"Contractual requirements largely account for any company to buy D&O insurance, whether from term sheet requirements of investors or requests from limited partners."

Carl E. Metzger, Goodwin Procter

Mason: Rising awareness certainly lends itself to purchasing D&O insurance. This has been heightened by a general view as to the frequency of litigation, especially over the last 18 months. So, while individuals and businesses may not be

doing anything different per se, personal risks are increasing given an aggressive plaintiffs bar leading to more litigation in differing areas. Contractual obligations also drive the purchase of D&O coverage. Venture, private equity and angel backed companies typically have term sheet requirements necessitating D&O coverage. But, as much as portfolio company D&O insurance benefits these types of asset management firms, they, in turn, need their own backstop of D&O insurance. Much of this revolves around the fact that a standard portfolio company D&O policy does not extend coverage to the asset management firm. A specialised policy referred to as 'VCAP', or Venture Capital Asset Protection, is best suited for that.

RC: What types of litigation are D&Os facing at this point? Are litigation trends increasing or decreasing relative to past years?

Mason: We have seen an uptick in claims activity in our private D&O and venture, private equity and angel book this year. The bulk of this litigation is exit centric, and has ranged from the typical dilution claim to successor liability to fraud to breach of contract. But alongside that, we have seen many claims associated with antitrust type of allegations, employment actions and insolvencies. A few things are worth noting. First, regardless of the potential frivolity of the litigation, it is a time drain on management, and it is expensive to defend. Second, the venture firm's board representative is most always named in the litigation, and an increasing trend is the inclusion of the firm or fund itself as a named defendant. Finally, a well-structured D&O policy has been a significant aspect in favourable claim resolution.

Metzger: For venture and private equity firms, the number of cases involving their portfolio companies where the fund itself is named in addition to its board representative is increasing, and this trend has been accelerating overtime. Firms cannot just rely on portfolio company D&O insurance to protect the fund, as there are so many types of claims that wouldn't be covered by that policy but would be covered by a VCAP policy. Leaders of venture firms are continuing to face an increased litigation risk in the ordinary course of doing business, and there is nothing to suggest that this is simply a fad that is likely to go away. When guarding against the risk of litigation for their organisation and senior individuals, asset managers need as strong protections in place as possible. This type of program is a critical component of that. These policies are extremely complex and how a complicated claim plays out, particularly with other parties with their own insurance in play, can be very difficult. Clients need to be very proactive in making sure the coverage program is as thoughtfully developed as it can be in light of how they run their business.

RC: Could you outline the differences and implications of duty to defend and duty to indemnify principles?

Metzger: There are some advantages in terms of coverage for defence costs under a duty to defend policy. In general, there is a heightened carrier obligation to provide a defence as it also provides for a 100 percent defence cost allocation between covered and uncovered matters. That said, we haven't seen material differences in outcome of how claims are treated. Needless to say, it is an important area to understand before there ever is a claim. Brokers and counsel should make sure that their client understands this coverage mechanism prior to purchasing coverage. It can be problematic when companies are surprised with the news that counsel that they would prefer to use for defence of a D&O claim is not necessarily on an insurer's approved counsel list, or that the carrier is not willing to pay the billing rates of that company's preferred counsel. These issues can arise even under a duty to defend type policy. In a situation where the carrier selects the defence counsel for you, it can be potentially problematic, particularly in terms of where the loyalties of that counsel really lie. If companies require assistance with coverage questions they may not be able to turn to counsel appointed by the insurance carrier for that type of advice. They may need to turn to separate counsel, at their own expense, in order to answer such coverage questions. In this situation, the client can end with a de facto allocation issue that they did not anticipate.

Mason: In a duty to defend policy, the insurer manages the overall choice of counsel and pays that counsel directly for the defence of the claim. The insured typically chooses from a list of 'panel' counsel that is pre-approved by the insurer relative to rate structure. In some cases, the insured may be able to use its own counsel if the firm is reputable and its rating structure fits guidelines of the insurer. While many insureds are reluctant to partner with a new firm in the face of serious litigation, there is a significant benefit to the insured in that most duty to defend policies offer 100 percent defence cost allocation between covered and uncovered matters. In addition, many insureds prefer a duty to defend policy as they don't want the hassle of searching for a specialty firm if the litigation is complex in different areas. In an indemnity policy, the insured has the ability to retain counsel of their choice, subject to approval of the insurer, relative to that firm's expertise and rate structure. The insurer reimburses the insured for defence expenses, which then remits for payment to the insurer. Even though the insured may have greater flexibility in the control of the defence, consideration needs to be given to potential problems if there has not been consent granted by the insurer for costs incurred in defence or settlement. Finally, an indemnity policy may not

have the significant benefit of 100 percent defence cost allocation.

RC: In your experience, what kinds of issues may lead to disputes over D&O insurance coverage? What steps can be taken to reduce potential disputes down the line?

Mason: A D&O insurance policy is a complicated contract. Certain policy provisions may expressly grant coverage, only later to be narrowed or removed. Definitions are critical – think Bill Clinton and what the word 'is' means. Like any other contract, the devil is in the detail, and a policy that is worded to the benefit of the insured is far more desirable than one that is blatantly restrictive. Attention needs to be focused on all aspects of the policy, as one section may totally contradict another. As ambiguity is the source of most disputes between an insured and insurer, tailoring a policy to meet the unique risks of an insured is key.

Metzger: I wouldn't say that there are coverage issues that are so dominant that we are constantly fighting over those same issues. Depending upon the nature of the litigation, so many different provisions of the policy can come into play and

raise coverage questions that need to be resolved with insurers. That's why it is so important to have strong coverage across the board before there ever is a claim. Business litigation can be very complex and the claims for damages and theories of recovery are being evolved and advanced by creative plaintiff lawyers as we speak. The D&O insurance industry cannot possibly anticipate the evolution of the various liability theories. There will always be a certain amount of coverage uncertainty depending upon the nature of the claims asserted. This simply points to why you need a thoughtful review of your policy and a solid brokerage firm that has scar tissue and experience in claims. An experienced and battle hardened firm which offers a robust policy will ensure that as good a job as possible is done in predicting the many complex claims scenarios.

RC: What advice would you give to entities in terms of selecting an appropriate D&O policy? What considerations should they make when evaluating differences in pricing and terms?

Mason: You need an advocate as your insurance broker, someone who specialises in D&O and the particular nuances associated with these policies. This goes far beyond the simple aspects of filling out an application for underwriters to assess your risk. I believe there are 'Five C's' in buying D&O insurance. The first is 'coverage' – is it robust and addressing the needs of your business? If you're buying multiple coverages under one policy, as is typical in private company coverage, are the limits separate or shared? The second is 'carrier' – do they have a large footprint in the space? What is their reputation? Are they 'brand name' recognisable? Third is 'continuity' – if you're changing insurers, make sure you don't need to re-warrant knowledge or suffer a gap in existence of pending or prior litigation. Fourth is 'claims' – what is the insurer's claims handling reputation? Do they have their own counsel, or do they outsource their claims handling?

> **"While a broad-based cyber liability exclusion is not commonplace in D&O forms today, the exposure creates significant coverage complexities and has direct correlation to the need to pay attention to policy detail."**
>
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> *Mason & Mason Technology Insurance Services Inc.*

What experience does your broker have in complex litigation? The last is 'cost', and there is more to this than just straight premium cost. If there are problems with the first four items, your total cost of risk – premium and uncovered claims – could be significantly higher.

RC: One of the most widely-discussed risks facing D&Os relates to cyber breaches and data security. In what ways can D&O insurance help corporate leaders to manage personal liability arising from this threat?

Metzger: This is an area of emerging litigation risk for the D&Os of any type of organisation, and will not be contained in the public company arena. If there are companies with significant breaches that impact other third parties adversely, whether their own stockholder base, or others customers, clients or vendors, those third parties will end up bringing litigation against the company that suffered the breach. D&Os may themselves have claims against them if aggrieved third parties believe that those D&Os were somehow negligent or failed to act responsibility in dealing with the breach. This is a hot button area of litigation risk. There may not be a tidal wave of claims against private company D&Os in the next year, but there will be more litigation and it will impact the leadership of organisations of all types as this risk continues to evolve.

Mason: Business leaders have always had the broad responsibility of helping their firms identify and manage key risk. Recall the frenzy of Y2K preparedness, environmental threats or more generic business continuity threats. In an age of advancing technology and sophistication of business transactions, protecting a business's assets, brand and its customers' information is critical. In the context of D&O coverage, cyber is not so different than the need to manage any risk. It is hugely prevalent and it has been, and will continue to be, a potential derailment to any business and its management team should a breach occur. While a broad-based cyber liability exclusion is not commonplace in D&O forms today, the exposure creates significant coverage complexities and has direct correlation to the need to pay attention to policy detail. Without question, it ramps up the importance of looking broadly at the policy wording and exclusions that could be problematic. It also necessitates the need to look at cyber specific coverages.

RC: In today's market, do you believe a robust D&O liability policy is necessary to attract the right calibre of talent to a firm's board?

Geshwiler: A D&O liability policy is a total litmus test. Anyone who will be a high quality director on the institutional or individual side will ask if there is

adequate coverage in place. They will know better to ask not just is there a policy in place, but how good it is. They may not get into the details, but they know there are differences.

Mason: Talent breeds talent, and when it comes to formation of a board of directors, businesses want excellence. Most savvy business people are very cognisant of personal liability associated with taking a board seat. Many times they have been a party subject to litigation at another company. As such, they want to ensure that they are protected by a solid D&O policy. Many private companies will also seek a separate 'Side A' policy, which can be limited to apply only to independent directors, to give these board members additional coverage in the event they are not indemnified by the company. The resounding answer here is never skimp on protecting your board.

Metzger: It is imperative that you have strong D&O coverage in place and it would be a mistake for the leadership of any type of organisation to neglect this area. It is often the thin line of strong coverage that allows D&Os to thwart personal liability. By and large, D&O litigation draws in individuals in their personal capacity but in decisions they have made in good faith as leaders of their organisation. It is enough of a pain to have to deal with being sued personally, but you should not, on top of that, worry that your personal assets are at risk. R&C

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