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Private Equity Update

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"Must Know" D&O: Answers to 10 Common Questions About Portfolio Company D&O Insurance

Directors and officers liability (D&O) insurance provides a critical layer of protection from the risk of personal liability for anyone serving on the board of a company. The insurance is especially important to private equity firms which have individuals serving on multiple boards. Understanding how D&O insurance really works, however, is not easy. To many, the policies seem arcane, and it is hard to figure out the actual coverage. What follows are answers to 10 common questions about D&O insurance.

1. When should a private portfolio company first get D&O insurance? Young private companies historically went without D&O insurance until they became much larger businesses or went public. That practice has changed. Now, even many early stage companies with relatively small operations have some level of D&O coverage in place. Why the change? First, the coverage being offered by the major D&O insurance carriers is better and cheaper (relatively speaking) than it used to be because the marketplace for D&O insurance has become more competitive and better developed. Second, the directors of even small companies are seeking increased protection from the threat of personal liability because of the perceived increase in risk associated with being on the board of directors of *any* company. Third, and in a similar vein, more private equity firms have adopted the risk management strategy of requiring that any new company in which they invest have some level of D&O coverage in place. Such private equity firms monitor the levels and scope of D&O insurance maintained by their portfolio companies to make sure that the coverages are sufficient as their companies evolve over time – a practice we believe makes good sense.

2. How much D&O insurance should a private company have? There is no formula or litmus test applied in the D&O insurance industry to answer this question. Many early stage private companies carry between $1 million to $5 million in limits, with more mature companies that have broader operations typically carrying $10 million or more in limits. This range is substantial, and ultimately the answer for any particular company will depend in part on how much risk a board of directors is – or is not – willing to assume. Key factors that should go into the analysis include: the sufficiency of the company's assets to cover fully its indemnification obligations owed to its directors and officers; the volatility and litigation risk profile of the company's business and industry; the scope and size of the company's operations; the future prospects and expected growth of the company; the likelihood of significant transactions for the company, such as merger or acquisition activity, an initial public offering or even a dissolution or bankruptcy; and, finally, the history of the company's relations (and disagreements, if any) with its business partners and significant shareholders.

3. How much will D&O insurance for a private company cost? The price of private company D&O insurance varies substantially depending upon the size of the company. For a modest-sized company, $3 million of D&O insurance can cost in the range of $14,000 to $20,000 annually. The insurance carriers which are underwriting the coverage will base their pricing in part on the same kinds of factors as those addressed in Question 2 above as well as on the coverages included within the D&O policy. Finally, the pricing per million dollars of coverage decreases with higher limits of additional coverage since the likelihood of those limits being subject to a claim also decreases.

4. What coverage does private company D&O insurance actually provide? If you are not sure of the answer to this question, you are not alone. The subject has been confusing to many because the name "D&O insurance" may be a misnomer in the private company context. In fact, many of the major insurance carriers which offer this insurance now have policies that provide coverage extending beyond a company's directors and officers.

Historically, D&O policies simply provided the traditional "breach of fiduciary duty" coverage for a company's directors and officers. While that limited form of insurance can still be purchased, the typical private company D&O insurance policy offers broader protection in two principal respects. First, the insurance typically is extended to include coverage for a wider group of insureds. Often, the company itself is an insured, as well as all of the employees of the company for certain types of claims. Second, the insurance offers coverage for a broader array of claims against such insureds, most notably including employment practices-related claims. These facts mean that the coverage under a typical private company "D&O" insurance policy actually has been expanded to provide protection against many forms of *corporate* liability. While this may be a good result for the company, it has the practical impact of diluting the coverage available solely to the directors and officers. Companies should carefully consider the true scope of their coverage and the need to secure a higher overall amount of coverage in order to provide adequate protection for the individual directors and officers.

5. Are the terms of coverage ever negotiated, or will the company be forced to accept the carrier's standard form policy language? While insurance carriers have standard form policies to begin with, the terms and conditions of D&O policies can be negotiated to improve the scope of coverage. Some insurance carriers have done a better job than others at updating their form policies to reflect coverage enhancements that have become commonplace in the current, competitive D&O insurance marketplace. Even so, your insurance broker and legal counsel may have recommendations for how the form policy can be further modified to benefit the insureds. Such coverage enhancements often can be negotiated *without* any additional charge in premium. Finally, no form policy can address the unique characteristics that certain companies present. A particular company's policy may need to be amended to account for an unusual corporate structure or a variety of other special considerations.

6. How should a company make sure that it is getting the best D&O insurance coverage possible? The company will need help. In all likelihood the company already has an insurance broker that it has worked with to secure other types of insurance such as general liability, property and worker's compensation coverage. Not all insurance brokers, however, have expertise in negotiating top quality D&O insurance, even if they have experience in placing other types of insurance. The company should find out from its existing insurance broker exactly what experience it has with placing D&O insurance. References should be asked for and checked. It is not uncommon for a company to retain a specialist for securing D&O insurance while maintaining its relationship with its original insurance broker for other, more routine coverages. If maintaining two broker relationships sounds too complicated, then the company should switch its entire insurance program over to a broker that has the depth of expertise to make sure that the D&O insurance is negotiated correctly.

Finally, the company's legal counsel should be involved in the process as well. Insurance policies are another form of corporate contract. Counsel will help advise the company and its insurance broker on points of law that may be critical to effectively negotiating the proper protections which safeguard the directors and officers from personal liability.

7. How does D&O insurance affect a director's rights to corporate indemnification? Having D&O insurance in place adds another, separate layer of protection for directors *in addition to* their rights to indemnification from the company. The D&O insurance does not reduce or change the company's indemnification obligations. In the event of a claim against a director, the D&O insurance typically will respond first to pay for that claim (including costs of defense, such as attorneys' fees). The company is required to pay only the policy deductible. In this manner, the D&O insurance becomes a source of funds to pay for liabilities that the company otherwise would have under its indemnification obligations. This obviously is helpful to protect the company's assets, but it also helps to protect the directors and officers when a company does not have sufficient assets to fulfill its indemnification obligations.

If the D&O insurance coverage is unavailable for any reason (such as a coverage exclusion), then directors can still rely on their indemnification rights to the extent that the company can pay for such liabilities. In addition, directors can still rely on any exculpation provisions found in the company's charter or bylaws. This means that, even if a company has D&O insurance, the directors will want to make sure that they have appropriate indemnification and exculpation rights. A private equity investor taking a board seat with a portfolio company should have counsel review the portfolio company's charter and by-laws to confirm that the indemnification and exculpation provisions are acceptable. Additionally, the private equity investor should consider seeking a separate, stand-alone indemnification agreement. These agreements strengthen a board member's indemnification rights and more clearly set forth the payment procedures for an indemnification claim.

8. If a portfolio company has D&O insurance, when does a private equity firm's own insurance provide coverage for a claim against a board designee? Many private equity firms now have their own insurance coverage for claims relating to the firm's operations and fund management. As one of the components of such policies, coverage is provided for the activities of the firm's designees on portfolio company boards. If a board designee is sued in connection with his or her role with a portfolio company that has D&O insurance, then insurance coverage under two different policies could apply. The private equity firm's policy, however, is last in line to be tapped. Indeed, the private equity firm's insurance policy typically is written on what insurers call a "double excess" basis, meaning that the private equity firm's policy will respond to such a claim only after *both* the portfolio company's D&O insurance and its indemnification obligations have been fully exhausted. Practically speaking, this means that the private equity firm's policy will likely only come into play when a portfolio company is insolvent or dissolved. Keep in mind, however, that the private equity firm's policy will immediately cover claims that are asserted directly against the firm or against the firm's managers in a capacity other than as a portfolio company board designee.

9. Does a board member still have D&O insurance coverage after stepping off of a company's board? Yes. D&O insurance policies provide coverage not just for the current directors and officers of a company, but also for the former directors and officers. There are, however, two important caveats. First, coverage for former directors and officers is only for claims that concern events occurring before the director or officer left the company and that relate to the individual's capacity as a director or officer of the company. Second, coverage for former directors and officers continues only to the extent that the company continues to purchase D&O insurance in the future. In other words, there must still be a current D&O policy in place at the time the claim is asserted and under which the claim can be submitted to an insurer. Insurers refer to this as "claims made" coverage. If the company does not continue its D&O coverage in this manner, then the former directors and officers will *not* have coverage available to them. They typically cannot reach back to the policy that had been in effect (but is now expired) at the time of the events at issue.

For companies that are being sold or are going out of business, this means that they will want to purchase a multi-year run-off D&O insurance policy (sometimes called "tail" coverage) that provides coverage for the former directors and officers after the company is no longer independently in business. Companies typically purchase this coverage (with the full premium paid up front) for a six-year policy period to allow for the statute of limitations to run out on all possible claims. Although run-off D&O policies are not uncommon, they can take time to negotiate properly depending upon the specific aspects of the transaction or dissolution. Care should be taken to leave time in advance of such events to allow for this important coverage to be implemented.

10. Can a private equity firm help its portfolio companies purchase better D&O insurance? Yes. We have seen a number of private equity firms work with their own insurance broker to develop a portfolio company D&O insurance program that takes advantage of the private equity firm's leverage in the D&O insurance marketplace. The way such programs work is as follows. The private equity firm's insurance broker develops a list of premium D&O policy enhancements that it would like to see any portfolio company have as part of a top quality D&O insurance policy. The broker then approaches the major D&O insurance carriers to determine their interest level in accepting such policy terms. The insurance carriers have a willingness to participate because it allows them to do business with more portfolio companies than they otherwise would have access to. In this type of program, portfolio companies are not required to purchase their D&O insurance from the selected carrier. Rather, the program simply allows the private equity firm to present the program as an option for the portfolio company to evaluate. The portfolio company may well find that the program enables the company to obtain more competitive D&O coverage than it could otherwise obtain negotiating on its own. When portfolio companies participate in the program, they are issued their own separate policy with their own designated amount of coverage as if they independently had purchased the policy. Such programs enable private equity firms to provide another "value add" to their portfolio companies, while at the same time enhancing the firm's own protection for its portfolio company board designees.

If you would like additional information about the issues addressed in this client alert or have other questions about D&O insurance, please contact:

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