



# CAMBRIDGE

## PROPERTY & CASUALTY

### SPECIAL REPORT

## **BUT WE'RE A PRIVATE CORPORATION AND DON'T NEED DIRECTORS & OFFICERS LIABILITY INSURANCE**

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Many privately owned corporations are under the impression that they do not need directors and officers liability insurance for a host of reasons, including:

- There is no significant risk to justify purchasing a policy.
- The bylaws provide that directors and officers are to be indemnified for losses so they do not have a personal exposure.
- The corporation itself cannot be sued for the acts of directors and officers.
- Such D & O insurance is prohibitively expensive and should be self-insured.

Federal and state authorities as well as individual shareholders and other affected parties are increasingly bringing lawsuits against corporate directors and officers, personally, to pay for losses allegedly incurred because of negligent acts, misconduct, or wrongdoing by the directors and officers.

The purpose of this Special Report is to dispel certain myths about directors and officers liability insurance that provides insurance for claims by third parties that a director or officer breached certain duties and obligations.

### **EXAMPLES OF DIRECTORS AND OFFICERS CLAIMS**

Many claims can be brought against directors and officers and these claims can be brought against publicly held corporations and privately held corporations. The following is a list of some examples of potential claims:

- Acquiescence in conduct of fellow directors engaged in improper self-dealing.
- Acts beyond corporate powers.
- Acts of executive committee.
- Allowance of covenant violations in long-term loan agreements.
- Antitrust violations, especially Sections 1 and 2 of the Sherman Act and Sections 3 and 7 of the Clayton Act.
- Approval of corporate acquisition with resulting loss of corporate assets.
- Attendance at directors' meetings and committee meetings was sporadic.

- Causing the corporation to incur unnecessary tax liabilities.
- Civil liabilities in connection with prospectuses and communications.
- Civil liabilities on account of a registration statement.
- Customer claims.
- Competitor claims for interference with their business.
- Compensation arrangements with key employees were unreasonable.
- Competition with corporation by the officers and directors indirectly.
- Conflicts of interest.
- Continual absence from meetings.
- Corporate debts and delinquencies.
- Corporate funds improperly expended in proxy contests.
- Corporate gifts or contributions were unreasonable.
- Declaration of dividends was unreasonable.
- Deceptive trade practices.
- Disclosure of material facts was inadequate.
- Employment practices claims by employees including sexual harassment, wrongful discharge, and discrimination. (This is more properly covered under an employment practices liability policy.)
- Fraudulent interstate transactions.
- Failure to withhold social security and income taxes.
- Fraudulent methods, misstatements or omissions involving material facts or engaging in fraudulent course of conduct in connection with the purchase or sale of any assets.
- Security in violation of SEC Rule 10b-5.
- Fraudulent reports, financial statements, or certificates.
- Government agency claims.
- Ignorance of corporate books and records.
- Improper repurchase of stock.
- Inadequate dividend payments.
- Inadequate investigation of facts included in public filings.
- Inducing corporation to commit breach of contract.
- Inducing or abetting corporation in commission of torts.
- Inducing or abetting willful wrongdoing by corporation.
- Inefficient administration resulting in losses.
- Informal dissolution or liquidation of corporation.
- Insider tipping.
- Insider trading.
- Interstate use of the mails in connection with sale of unregistered securities.
- Liability of controlling persons.
- Loans by corporations.
- Loans from officers, directors, or shareholders.
- Loans to officers, directors, or shareholders.
- Merger acquisition disputes.
- Misuse of insider information.
- Neglect of proper management with respect to corporate debts and delinquencies.
- Patent, copyright or trade-mark infringement. (Although this is a potential claim, it is typically excluded under corporate liability coverage but could be covered as respects individual officers and directors.)
- Periodical and other reports under securities act and corporation laws.

- Third party discrimination claims or sexual abuse by employees.
- Timely disclosure of material facts.
- Transactions between corporations having common directors.
- Transactions with other companies in which officers or directors are personally interested.
- Treble damage liabilities under antitrust laws.
- Unauthorized acts in connection with liquidation of corporation.
- Unfair competition.
- Unreasonable accumulations.
- Use of corporate funds in proxy contests.
- Violations of specific provisions of articles or by-laws.
- Violations of state statutes.
- Wasting of corporate assets.
- Willful wrongdoing.
- Failure to purchase insurance or purchasing inadequate insurance or insurance from insolvent insurance companies or captives.
- Foreign currency violations.
- Violation of the Americans with Disabilities Act.

### **SOURCE OF CLAIMS**

A study done by Wyatt & Co. examined the total number of claims against officers and directors and found that 52% of the claims were brought by shareholders, 22% by employees, 16% by customers, 2% by competitors, 3% by the government, and 5% by others. These exposures apply not only to publicly held corporations but also to private corporations.

### **PERSONAL ASSETS ARE AT RISK**

Directors and officers that serve without directors and officers liability coverage do so at their own peril, and that peril could be the loss of their personal assets because of legal fees and judgments. A variety of policies are available to both public corporations as well as private and nonprofit corporations and even partnerships and LLC's for many, but not all, of these types of exposures. However, standard general liability and umbrella policies do not cover most claims against directors and officers unless there has first been bodily injury, property damage and certain personal injury perils, and even then employment practices type claims and other claims are often excluded.

### **CORPORATE INDEMNIFICATION MAY BE ONLY A PARTIAL SOLUTION**

Many directors are under the false impression that the corporation is required under Michigan law to indemnify them for officers and directors liability claims made against them. In Michigan, the corporation must indemnify the officer and director for non-derivative suits made by third parties against the director or officer in his or her capacity as such.

This is also available if the director or officer was serving on another corporate board at the request of the primary corporation.

This indemnification requires that the director or officer acted in good faith and in a manner he or she reasonably believed to be in or at least not opposed to the best interests of the corporation.

As respects lawsuits from shareholders, however, no indemnification shall be made as respects any claim or matter in which such person was adjudged to be liable for negligence or misconduct in the performance of their duties to the corporation.

## **THERE ARE MANY DIFFERENT TYPES OF POLICIES AVAILABLE**

Therefore, a comparison study of terms, conditions and exclusions is important.

### **A. Exclusions**

Directors and officers liability policies do have exclusions and one of the most important exclusions pertains to pollution liability. In recent years, management has been increasingly held accountable for the strategic decision making on environmental matters within the corporation. This means that the shareholders expect that certain components of an environmental management program will be in place for the corporation.

In addition to the basic elements of environmental management programs, which is the legal responsibility of directors and officers, it is also expected that the directors and officers will properly represent and protect the shareholders during such extraordinary events as mergers and acquisitions in which environmental liabilities might be acquired along with assets.

Inasmuch as officers and directors liability policies typically exclude pollution liability claims, a separate environmental legal liability policy should be secured. An additional exclusion to be considered is the punitive damage exclusion that is common to many officers and directors liability policies. Punitive damages are designed to punish what the jury views as wrongdoing, especially egregious behavior. A directors and officers liability policy should not have punitive damage exclusions if these can be negotiated away for an additional premium.

In addition to some of the exclusions we discussed above, most directors and officers liability policies exclude (policies vary - review any directors and officers policy carefully):

- Bodily injury, mental or emotional distress, sickness, disease, or death. (Some of these types of claims would be covered under the commercial general liability policy.)
- ERISA or similar obligations are also excluded. (These claims can be covered under a fiduciary liability policy.)
- Violation of securities acts or similar acts without notification and approval by the insurance company.
- Wrongful acts after the date the insured person ceases to serve on an outside board.
- Employment practices claims. (This coverage can be endorsed on to many directors and officers liability policies or can be purchased under a separate policy.)
- Fraudulent acts or omissions by the insured person.
- Insured vs. insured claims.
- Personal profit or advantage to which an insured person is not legally entitled.

### **B. Entity Coverage Should Be Considered**

The corporation itself can be sued for acts of directors and officers in a lawsuit known as a derivative action suit brought by the shareholders. It should be noted that directors and officers

liability policies are designed to cover directors and officers and not the corporation; however, there are some exceptions to this.

It is possible under certain officers and directors liability policies to obtain separate entity coverage, also known as corporate liability coverage, for many of these claims. Entity coverage, however, has numerous limiting exclusions such as fraudulent acts or omissions of the corporation; illegal profit or advantage of the corporation; copyright, patents, service mark, trade name or misappropriation of ideas or trade secrets; as well as breach of contract and the cost of injunctive relief or previous judgment.

Because of these exclusions, entity coverage is relatively limited. A disadvantage of having entity coverage is that it erodes the limits that are available to the directors and officers personally. This can be partially offset by a dedicated limit for executives.

### **C. Claims-Made Nature of Coverage**

Generally, directors and officers liability policies are claims-made policies which means they cover claims that are made during the policy period, or during the optional extended reporting period if available under the policy.

As such, a directors and officers liability policy should be continuously maintained because wrongful acts committed during a previous policy period when coverage was in effect would not be covered if the claim for that wrongful act was made after the policy is cancelled or non-renewed.

### **D. Combination Policies Are Often Preferred**

Combination policies are available to cover not only directors and officers liability but employment practices, outside directorship liability and fiduciary liability.

The advantage of a combination policy is that for low exposure enterprises, one limit would be available for any of these exposures at a premium that is generally less than the sum of purchasing separate policies.

The disadvantage, of course, is that a claim in one area (for example, under the employment practices section) would erode the aggregate limit available under the director and officers liability section.

### **E. Pricing May Be Less Than You Think**

D & O insurance is available from a wide variety of insurance companies, including many specialty insurance companies. Of course, the premium is based on the number of employees, the size and financial stability of the organization, and its loss history, so premiums vary. However, in most cases D & O coverage is affordable and should be strongly considered as a staple to your property and casualty insurance program.