

Why Do Insureds Need D&O Insurance?

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No doubt, you've often been asked by insureds or prospects why they need D&O insurance or any other type of liability insurance other than CGL and auto. In this article, we'll present some reasons why CGL isn't enough, some statistics, several claims examples, and finally some internet resources to further your learning.

Types of Liability Insurance

CGL Insurance

A CGL policy covers an insured's legal liability for an occurrence that causes "bodily injury" and "property damage," as defined by the policy. Unfortunately, officers, directors, employees, and others can be sued for wrongful acts, misjudgments, mistakes, errors, and omissions that cause financial harm not meeting the definition of "property damage" and, thus, triggering coverage.

And, even if coverage is triggered, there may be exclusions that remove coverage for acts such as discrimination and sexual harassment. In addition, exclusions for professional liability are often endorsed onto the CGL policy. Therefore, many organizations need separate coverage for certain exposures not covered by the CGL policy.

D&O Insurance

A D&O policy typically covers "wrongful acts" by directors and officers of an entity within their capacity to make decisions regarding the entity's activities. A "wrongful act" is often defined to be something like, "any error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted, by an insured person, individually or otherwise, in an insured capacity, or any matter claimed against him or her solely by reason of his or her serving in such insured capacity."

The entity may be a public or private corporation, association or other organization and it may be for-profit or nonprofit. If the D&O policy excludes wrongful acts

arising out of the provision of "professional services," a separate E&O or other type of professional liability coverage may be needed, although some D&O policies now package E&O, EPLI, and sometimes fiduciary liability insurance.

E&O Insurance

An E&O professional liability policy covers wrongful acts of a "professional" capacity and typically is purchased by "professionals" such as doctors, lawyers, engineers, architects, teachers, insurance agents, and many other persons who perform services in a professional capacity.

Some claims that would otherwise be covered under a D&O policy must be covered under an E&O policy because they involve acts outside the capacity of the insured as a director or officer, involve acts excluded by the D&O policy because of the "professional" skill nature of the service or decision (e.g., sponsorship or administration of group insurance plans), or are committed by someone not defined as an insured under the D&O policy.

EPLI Insurance

Employment Practices Liability Insurance covers those defined as insureds for various types of employment claims, including wrongful termination, discrimination, and sexual harassment.

Fiduciary Liability Insurance

Fiduciary liability coverage covers an insured's breach of fiduciary duties, often with regard to pension, savings, profit-sharing, employee benefits, and health plans, including ERISA violations.

Who Can Sue?

Directors and officers can be sued by the entity itself or by other current or former directors and officers, employees, shareholders, investors, lenders, vendors, customers, competitors, various government officials such as state attorney generals, the IRS, and state and federal labor departments, consumer groups,

and many other third parties. Since D&O policies typically include an intentional acts exclusion, the policy should include a severability clause so that coverage is afforded to an innocent insured who did not participate in such acts (think Enron). It is usually a good idea to include the organization as an insured in addition to the directors and officers...this can typically be done by endorsement and often at no additional charge.

Types of Actions

There are generally two types of actions for D&O lawsuits:

Derivative suits by shareholders or members suing for poor performance, incompetent management, mistakes, bad judgment, etc.

Non-Derivative suits from all other parties, particularly employees.

Type of Claims

The following are brief, representative examples of claims typically addressed by the professional liability policies outlined above:

- ◆ Providing inaccurate financial information to a lending institution
- ◆ Providing inaccurate information to a surety bonding company
- ◆ Exercising poor due diligence in a business acquisition
- ◆ Receiving deposits for future services and failing to deliver those services (retirement community)
- ◆ Wrongful termination of an employee
- ◆ Discrimination against a customer
- ◆ Sexual Harassment of an employee
- ◆ ADA violations

Claims Examples

The following are some actual D&O lawsuits as reported by various sources:

A minority shareholder in a family-owned electrical contracting business sues the two major shareholders on behalf of the company, claiming they breached their fiduciary duties. The minority shareholder claims that the majority shareholders, by drawing excessively large salaries and bonuses, caused the company to lose money. The court rules in favor of the majority

shareholders, but the defense costs amount to \$150,000.

A mid-sized manufacturing firm hires an employee away from one of its competitors, bringing the person on as an officer. A year later, that new officer's ex-employer sues the officer and his new firm, alleging that the officer misappropriated trade secrets and violated certain provisions of its termination agreement.

A Midwest domiciled home products company retained an independent research firm to evaluate its new home product. Based on a favorable review by the outside firm, the company raised in excess of \$10 million for the production and marketing of the new product. Prior to releasing the product, the company's internal evaluation team discovered, after extensive testing, that the new product did not work properly. Shareholders have brought suit against the company and the directors and officers for misrepresentation in the offering documents. The plaintiffs assert causes of action for violation of various state securities laws and the Securities and Exchange Act of 1934. Damages alleged in the lawsuit exceed \$15 million.

A shareholder commenced a derivative action against the president of a company which develops and markets chemical compounds, after all its assets were sold. The company entered into an agreement to allow a corporation to test and evaluate its compounds. The corporation subsequently received various patents for the compounds, however, it refused to enter into a licensing agreement with the company. The plaintiff concludes that the company can assert causes of action against the corporation for: breach of contract; breach of fiduciary duty; misappropriation of trade secrets; unfair competition; fraudulent concealment; and intentional misrepresentation. The plaintiff also alleges the company series B shareholders did not approve certain loans. Subsequently, after

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the company defaulted on the loans, the president decided to execute a foreclosure sale of the company's assets and he advised the shareholders that he is resigning. The plaintiff alleges that the president did not promptly advise the shareholders of the foreclosure sale and he breached his fiduciary duties when failed to have the Company commence litigation against the corporation that was retained to test its compounds. The complaint is comprised of four causes of action, including: (1) negligence, (2) breach of fiduciary duty; (3) concealment; and (4) unfair competition. Total defense costs and settlement exceeded \$750,000.

The plaintiff filed a complaint against their competitor alleging that a former employee, now working at the competition, engaged in unauthorized use of confidential and proprietary information and committed other acts of unfair competition. As a result, the plaintiff alleges it has suffered irreparable and immediate injury. In addition, the plaintiff alleges that the defendant has possession of its confidential information and intellectual property. The plaintiff asserts causes of action for: (1) misappropriation of trade secrets and confidential information; (2) violation of the Computer Fraud and Abuse Act (3) unlawful access to stored information; and (4) unfair competition. The plaintiff seeks: (1) attachment of a computer server; (2) attachment of certain files and documents; (3) injunction - preservation; (4) injunction - proprietary information; (5) injunction - surrender of possession; (6) injunction - non-compete; (7) compensatory damages; (8) exemplary and punitive damages; and (9) attorneys' fees and costs. Total defense costs and settlement exceeded \$350,000.

A diversified sports product company received a lawsuit against the President, CEO, and Chairman of the Board for not honoring a promissory note. The plaintiff alleges that it lent \$1

million to the company. The company allegedly agreed to pay the funds back within a month pursuant to the promissory note. Despite requests for return of the money, plus interest, the company has not returned the funds to the plaintiff. Total defense costs and settlement exceed \$250,000.

A technology company received a complaint from an investor who alleges the company improperly induced the plaintiff to issue a note payable to the company. The plaintiff specifically alleges the company made false representations and other false statements regarding the company's forecasted rate of growth and failure to disclose its tax lien. The company defaulted on the promissory note when it failed to make the required principle and interest payments. The plaintiffs issued a demand letter and filed suit against the company. The plaintiff agreed to accept the company's offer to convert the promissory note to stock in the company, but the defense costs exceeded \$100,000.

A class action suit was commenced by various investors who participated in an internet startup company's a Private Placement that raised in excess of \$5 million to fund capital expenses, to provide working capital and to cover operating losses. An investigation made by and through counsel, primarily from corporate records and public records and documents shows that the Private Placement Memorandum contained an unaudited year end balance sheet and statement of profits and losses which were materially misleading. Total defense costs and settlement exceeded \$500,000.

A private company that manages and runs a major natural resource receives a claim against the company and various members of the board of directors. The plaintiff alleges that the board of directors have used their position for their own private benefit and personal advantage, and for the benefit and advantage of their

private employers. The plaintiff also alleges that the board of directors assigned a valuable contract without receiving any consideration. The plaintiff further alleges that such assignment also constitutes misappropriation of valuable assets for the benefit of private party in violation of state codes. Total defense costs exceeded \$250,000.

The federal government sued the CEO, the President and other officers of an East Coast manufacturing company for price fixing. After an extensive trial, the allegations were dismissed due to lack of circumstantial evidence, but the defense costs and fees incurred were in excess \$750,000.

A private company agrees to perform market research for a start-up company in the material management industry. In exchange for their services, the company allegedly agrees to pay the private company \$20,000 in cash and 5% of the privately placed issued shares in the company. The company denies that they explicitly or implicitly agreed to pay the private company in stock. The plaintiffs allege several causes of action, including breach of fiduciary duty. Total defense costs and settlement exceeded \$800,000.

A shareholder derivative action is taken against a company for breach of fiduciary duties on behalf of the directors. The plaintiffs contend that the defendants have failed to provide them with certain information, such as shareholder listings, financial data and other corporate records. They also allege that certain directors borrowed money from the company without the Board's approval and subsequently these loans were forgiven. Total defense costs and settlement exceeded \$500,000.

A company enters into an investment agreement with a third party and agrees not to negotiate with other entity regarding financing or a potential acquisition for a two-week period. During the exclusivity period the

company engages in negotiations with another investment group. The third party alleges breach of investment agreement and intentional and negligent misrepresentation. Total defense costs and settlement exceeded \$350,000.

Other Resources
For more in depth information on all things D&O related check out <http://www.irmi.com/Expert/Topics/CommercialInsurance/Fiduciary.aspx>

Markets
Through Big "I" Markets (www.bigmarkets.com) you have access to several commercial liability products (as they appear on the Big "I" Markets product commercial products menu) including:

- ◆ Employment Practices Liability Wrap + (Travelers)
- ◆ Employment Practices Liability (wholesaler)
- ◆ Fidelity & Crime Wrap+ (Travelers)
- ◆ Non-Profit D&O (Philadelphia)
- ◆ Wrap+ (Bundled coverage options including EPLI, D&O, Fiduciary, Fidelity & Crime, Kidnap/Extortion, and identity theft via Travelers)

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