

Just because the corporation is not publicly traded does not mean it has not issued a "security" that is subject to U.S. securities laws. Many forms of instruments can be classified as a security for scrutiny by the Securities and Exchange Commission.

In addition, directors and officers of privately held corporations owe the same duties to shareholders as do their counterparts at publicly held corporations. And it is no safe harbor that, for example, all of the shareholders of a privately held corporation are relatives of friends. Friends one day can be bitter enemies the next, even when they are relatives. If you think differently, follow the saga of divorce law in the United States.

And it also is no safe harbor that a director or officer merely is acting on behalf of the corporation. The individual still can be personally liable for his or her acts on behalf of the corporation. Indeed, it has been argued by some experts that directors and officers of privately held corporations are at more risk of claims because most privately held corporations simply do not have the same resources as large publicly held companies, so that many decisions by directors and officers of privately held corporations are made without full or accurate information.

What types of claims have been made against directors and officers of privately held corporations? Here are descriptions of several claims I have gathered from different articles on this subject. In most instances, the claims described would not be covered under CGL insurance or any other insurance that companies typically purchase, but could be covered and typically are covered under D&O insurance.

Claims by Shareholders

A variety of different types of shareholder claims have been made in the past, and continue to be made. Some claims allege there were breaches of the duty of candor with respect to misrepresentations in and/or omissions from private-placement materials.

Some claims allege there were breaches of the duty of care with respect to how the directors and officers handled the sale of the corporation, or how they missed a great opportunity for the corporation.

Some claims allege there were breaches of the duty of loyalty with respect to deals the corporation had entered into with companies owned in whole or in part by one or more of the directors and/or officers.

Claims by Employees

Several types of claims have been made by employees, with alarming frequency, in the last several years, especially in the area of employment practices liability (i.e., claims for wrongful termination, discrimination and harassment). Such claims have been in the form of both allegations of actual wrongful termination, discrimination or harassment, as well as of negligent

supervision and/or failure to follow up with respect to complaints of wrongful termination, discrimination or harassment.

Claims by Competitors, Customers

As noted previously, directors and officers of privately held corporations face claims by any party with which the corporation contracts or even discusses a contractual relationship (whether competitor, customer or other contracting party). Because many contracts and other negotiations for privately held corporations are handled by an officer of the company (especially for smaller privately held corporations), officers are at risk for claims arising out of their contracting and negotiating activities.

The personal experiences related at the beginning of this article bear out this risk in spades.

Claims by Government Agencies

A variety of claims can be made by government agencies against the directors and officers of privately held corporations. Such claims vary from those relating to environmental contamination to employee health and safety. In addition, privately held corporations in certain industries, such as financial institutions, can face investigations and claims by certain regulatory agencies with respect to suspected or actual wrongdoing.

Non-Indemnifiable Claims

OK, so after reading all of what is discussed previously, the directors and officers of a privately held corporation still are not convinced that D&O insurance should be purchased. What I often hear is, "The corporation will reimburse us for any claims. Therefore, we don't need to buy any D&O insurance."

Is that a sound position? Not in my book. A fact commonly overlooked by many directors and officers is that certain D&O claims are not indemnifiable by the corporation. Certain shareholder derivative actions are perfect examples. Some are intended to force directors and officers to put money back in to the corporation's coffers, after the directors and officers commit wrongful acts that cause the corporation to lose money or other assets with value.

If the corporation were to reimburse the directors and officers for such claims, the whole purpose for such a derivative action would be defeated. Thus, many of such claims cannot be indemnified by the corporation.

The only thing standing between the claim and the personal assets of the directors and officers, therefore, is D&O insurance. If no D&O insurance is available, the money will come from the personal assets of the directors and officers.

There is another type of non-indemnifiable claim. This one is well known but never appreciated. It's the claim that can be indemnified by the corporation but because the corporation is insolvent, it has no money to indemnify the

directors and officers. The corporation's insolvency is not a defense to a D&O claim.

Thus, as with claims that are simply non-indemnifiable (such as certain types of shareholder derivative claims as noted previously), directors and officers facing claims when their corporation is insolvent likely will have to pay defense and indemnity costs out of their personal assets, unless D&O insurance is in place to provide coverage.

Spouses, Estates Exposed Too

Another little known fact is that the spouses and estates of directors and officers also are exposed to the liability faced by directors and officers. It is often, therefore, very simple to extend coverage under a D&O policy to the spouses and estates of directors and officers, with respect to claims against such directors and officers. (The policy will not respond to claims against a spouse for conduct of the spouse.)

Even if a director or officer is willing to take the risk of uninsured loss for himself or herself, it seems very, very wrong to me that the director or officer also is willing to expose his or her spouse to such uninsured liability, knowing of the risk of such liability.

I hope this column can be used for its two intended purposes. If you are an agent or broker who wants to know more about the risks faced by directors and officers of privately held corporations, this article should provide you with information that can serve as the beginning, or continuation, of your knowledge on the subject. If you are an agent or broker who wants to advise a client on the need for D&O insurance for privately held corporations, this column can help you as well.

I am sure that some readers will decry this column as "fear-mongering" for some clandestine purpose (to generate money for me or my firm, perhaps?). The fact of the matter is, I have thought about writing this article for nearly a year now, and I wrote it for one simple reason: I don't ever want to see another director or officer face the ordeal of defending against a D&O claim without having D&O insurance.

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