DIRECTORS AND OFFICERS LIABILITY LOSS PREVENTION GUIDELINES

for Privately Held Companies

DIRECTORS AND OFFICERS LIABILITY LOSS PREVENTION FOR PRIVATELY HELD COMPANIES

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FOREWORD

Although director and officer liability issues are well-recognized for publicly traded corporations, many privately held corporations largely ignore these issues because of a mistaken belief that their directors and officers cannot or will not be sued. In reality, a variety of parties in many contexts can and do bring claims against directors and officers of privately held companies. As a result, recognizing and responding to that risk should be an important focus for any privately held corporation.

As one of the world's leading writers of directors and officers (D&O) liability insurance, Chubb believes the best executive liability risk management strategy combines several techniques, including quality D&O liability insurance, sound corporate governance practices, and expert legal assistance. Chubb asked Dan A. Bailey, Esq., a nationally recognized authority on D&O issues, to prepare this exclusive D&O liability loss prevention booklet to help business leaders protect themselves and their corporations against claims and litigation. In the pages that follow, Mr. Bailey reviews the basic duties of directors and officers and summarizes many D&O liability loss control procedures applicable to privately held corporations.

We at Chubb hope this booklet will begin a process of education and guidance for the executives within your organization. Our intent is to help your company develop effective loss prevention strategies, *but no booklet is a substitute for expert legal advice*. We strongly encourage you to seek competent counsel for specific issues when they arise as you design and implement your organization's loss-control procedures.

INTRODUCTION

Risk management, or loss control, is a concept well-known to modern corporate management. Most businesses take precautionary measures to minimize the risks associated with fire, theft, product liability, work-related injury, and other common business exposures. Over the past decade, the benefits of a well-designed executive protection risk management plan, once recognized only by larger corporations, have become increasingly apparent to business entities of all types and sizes, including privately held corporations. In addition to the clear risk reduction benefits, proactive management of D&O liability exposures can improve a company's ability to recruit talented managers, enhance the quality of corporate decision making, and contain the cost of D&O liability insurance premiums. Improved governance practices should be viewed as being good for business, not as useless distractions.

The fundamental goal of any D&O liability loss prevention program is to sensitize the company's executives to the fact that almost everything they do creates the potential for second-guessing and perhaps claims by persons adversely affected by their actions and decisions. Once that mind-set exists, the executives will naturally apply commonsense caution, which is the single most important element of any loss control program.

The absence of public shareholders does not insulate private company directors and officers from liability exposure. Although private companies obviously have far fewer shareholders than publicly held companies do, those shareholders can and do become disgruntled plaintiffs in claims against a company's directors and officers. In addition, other company constituents and third parties can bring claims, including employees, creditors, vendors, customers, competitors, and regulators. In some respects, these claims can be more problematic than public company D&O litigation in light of the unique nature of private companies. For example,

- A private company may be dominated by a dominant shareholder or a small group of controlling shareholders, in which case the outside directors have more pressure to protect the interests of the minority shareholders.
- The directors frequently are personal friends or relatives of the CEO or dominant shareholder and receive very little, if any, compensation, thus discouraging active and independent oversight by the directors.

- The private company usually has limited resources to support the directors' decision-making process and to indemnify directors and officers when a claim is made.
- Shareholder disputes can be highly emotional, and new shareholder perspectives can arise unexpectedly through a shareholder's death, divorce, bankruptcy, or other significant event.
- The private company frequently has a small margin of error; therefore, many poor management decisions may be much more visible than in public companies.
- Strategic decisions such as selling the company or conducting a public offering of securities can create strong discord among shareholders who have different economic needs or visions of the company.

The distinction between higher-risk public companies and lower-risk private companies is now blurred because of the federal JOBS Act of 2012. Under that legislation and the SEC rules implementing it, a "private" company can raise millions of dollars by selling securities to thousands of investors without becoming an SEC-reporting "public" company. The philosophy underlying the JOBS Act is to encourage capital investment in private companies by replacing to a large extent pre-offering regulation and disclosures with post-offering litigation against the company and its directors if investors believe with 20/20 hindsight they did not receive full, accurate, and truthful information when making their investment decision. If private companies utilize the benefits of the JOBS Act, their D&O liability risks and their need for effective loss control practices certainly increase.

Basic Executive Duties

Directors and officers of private (as well as public) companies have the following three basic duties while performing their corporate functions. Their decisions do not need to be flawless, but when fulfilling these duties, directors and officers should act with the reasonable belief that they are pursuing the corporation's best interests.

Duty of diligence—Also called the duty of care, this duty requires executives to act in good faith and consistent with what a reasonably prudent person in a comparable position would do under similar circumstances. Prior to making a business decision, directors and officers need to obtain and consider all material information reasonably available to them. In addition, they should make a reasonable effort to monitor corporate activities.

Duty of loyalty—This duty precludes directors and officers from engaging in personal conduct that would injure or take advantage of the corporation. They should seek to avoid any appearance that they have misused their position of trust for their private interests. Examples of prohibited actions include the following:

- Gaining a secret profit or unfair advantage through personal transactions with the corporation.
- Competing against the corporation to its detriment or usurping a corporate opportunity.
- Profiting from the use of material, non-public corporate information.

Duty of obedience—This duty requires directors and officers to conform both their own conduct and the corporation's activities to applicable statutes and the corporate charter. Directors and officers may be liable if their conduct violates a statute or if they cause the company to act illegally or outside its legally authorized powers.

Business Judgment Rule

Even for decisions that may later prove to be mistakes, directors and officers are presumed to have satisfied their basic duties if the business judgment rule (BJR) applies. This important defense protects directors and, in most states, officers who make informed and disinterested business decisions in good faith. If appropriate procedures are followed, courts will not second-guess the quality or wisdom of the decision. However, the BJR does not apply if no actual business decision was made, such as situations in which directors ignore or fail to recognize an issue.

Composition of Board of Directors

A company should select each director for the sole purpose of maximizing benefit to the company.

Where possible, the size and composition of the board of directors should be determined based upon the company's unique requirements and the following considerations:

Director Attributes

The qualities of an effective director include integrity, an inquiring mind, practicality, and mature judgment. A director should have sufficient time and interest to devote the necessary energies to the required job. Persons with expertise or experience in different substantive areas affecting the corporation and with different perspectives may provide desirable breadth and diversity to the board. The number of other boards on which a prospective director serves should be considered to determine whether the director could realistically commit the necessary time for service on this board.

Independent Directors

To be effective, a board must be independent from management and not merely a "rubber stamp" for officers. Courts frequently recognize a greater presumption of good faith when a majority—or at least a substantial percentage—of a board consists of independent, outside directors. When evaluating a director's independence, a company should consider all economic, social, business, and familial relationships between the director and senior management as well as any controlling shareholders. The ultimate question is whether the director will feel constrained in any way from opposing management if necessary.

Size of Board

Many private company boards are relatively small (for example, five to seven members). That size may be conducive to active director participation in meetings but limits the ability of the board to perform in-depth analysis of issues through various board committees. Somewhat larger boards should be considered to provide greater diversity and depth.

Self-Evaluation

Although now common with public company boards, few private company boards periodically analyze their overall performance and the performance of individual members. This evaluation process can be a valuable governance tool to identify strengths and growth opportunities for the directors as well as to incentivize quality behavior. Topics covered in evaluations can include board procedures and performance as well as individual directors' attendance, participation in discussions, quality of contribution, preparedness, and availability to management. Evaluations should be considered when deciding whether to nominate a director for reelection.

Education

A company should develop a thorough orientation for new directors and officers and an ongoing education program for all directors and officers.

Directors and officers should be well-informed about the company's business lines, its competitive and regulatory environment, and the legal arena in which it operates. Because the factual and legal conditions affecting the company constantly change, the need for education is continual.

Factual Orientation

A factual orientation is particularly important for new directors and officers. Directors and officers may be personally liable for wrongful conduct regardless of how new they are to their positions; therefore, directors and officers should become fully informed contributors as quickly as possible. New directors should become familiar with the company's financial statements, company products, descriptions of board committees, biographies of the current directors and senior management, management letters from independent auditors, corporate facilities (including a tour when possible), and the company's outlook with respect to current prospects and problems, critical issues, primary risks, and long-range objectives.

Legal Education

The initial and ongoing education of directors and officers with respect to legal principles must be tailored to the unique set of legal standards applicable to the particular company. Among other things, the standards depend on the type of business, state of incorporation, other locations where the company does business, industry in which it competes, and the articles of incorporation and bylaws.

Internal Guidelines

The board should ensure proper education of officers and employees. Among other things, directors should develop, publicize, maintain, and enforce appropriate management policy statements defining ethical standards and legal guidelines with respect to various potentially sensitive or misunderstood areas, including the following:

- Conflicts of interest.
- Antitrust compliance.
- Proper accounting and financial integrity.
- Bribes and kickbacks.
- Political contributions.
- Harassment and discrimination.
- Misappropriation of corporate assets or opportunity.
- Confidentiality of corporate information.

The board should develop, with the assistance of legal experts, corporate policy guidelines for these areas. All employees should participate in training programs regarding the importance and the content of the guidelines and should sign a statement acknowledging and agreeing to the corporate policy. Senior management should be fully committed to enforcing the guidelines, regardless of any violator's rank. The company should periodically review and update its guidelines in view of new regulatory developments.

Such practices may not stop intentional wrongdoers, but they will educate and guide employees on avoiding illegal conduct, and they may prevent the corporation and its directors and officers from being charged with wrongdoing (or at least mitigate the severity of sanctions imposed) when a subordinate employee violates the guidelines.

Compliance Programs and Internal Controls

Directors should implement legal compliance programs to detect violations of law, and they should promptly report violations to appropriate public officials and take remedial actions. Although the type and design of such programs will vary among corporations, any program should sufficiently assure the board that the company's information and reporting systems are adequate to inform the board in a timely manner of appropriate compliance information. Directors should also ensure that the company has adequate internal controls and receive periodic reports from auditors and others regarding the effectiveness of those controls.

Board Meetings

Any action taken by directors must be an informed decision based on a thorough, well-documented investigation of all relevant facts reasonably available and applicable law.

The board (not just senior management) should periodically review various procedural practices relating to board meetings, including the following:

Schedules

Regular attendance at meetings is imperative to keep directors informed and to provide the opportunity for meaningful input into the decision-making process. A company should establish a regular meeting schedule, preferably on a yearly basis, and communicate the dates to the directors well in advance. Special meetings should be scheduled to maximize attendance to the extent possible.

Attendance by Non-Directors

Only directors have a legal right to attend board meetings, but officers, counsel, and others who have been involved in or are knowledgeable about particular matters under consideration should either attend meetings or remain available as needed.

Duration of Meetings

Time spent deliberating a decision does not always equate to quality decision making. Yet time spent in deliberation is an indication of the degree of care exercised by the board, and a full analysis and discussion, particularly for a complex corporate transaction, requires adequate time. Every director should have the full opportunity to question any aspect of an item under consideration.

Presentation of Information

Directors should receive information concerning important matters well in advance of the meeting. A detailed agenda, background information, committee minutes, and minutes of the previous board meeting should be distributed one to two weeks in advance. If special circumstances do not permit advance notice, time should be set aside at the meeting for directors to review and understand the information presented.

Preparation for Meeting

Each director should critically analyze all available information before a meeting to maximize the time spent on discussing the issues. As a rule, directors should plan to devote three hours of preparation for each hour of board meeting.

Conduct of Meeting

Board meetings should be conducted in an unbiased manner, encouraging candor, open discussion, and active questioning of management and outside advisors. The goal of board discussion is not simply to reach consensus but also to exercise a healthy skepticism and to air different viewpoints. Insiders should never stifle open discussion among board members, because unchallenged reliance upon management's recommendations subjects directors to potential liability. Inevitably, not all directors will agree with all board decisions. In that case, a dissenting director should actually vote against the proposal if he or she wishes to establish a legal defense based on the dissent. Courts typically view mere abstention as tantamount to approval.

Minutes

An accurate set of minutes of board and committee deliberations is one of the most important (and most frequently neglected) areas of D&O liability loss control. Board minutes should clearly set forth exactly what occurred at a meeting, including limitations placed on any action taken or authority granted and identification of any conscious decision not to act. Documents incorporated in or attached to the minutes should be clearly identified in the minutes. Each vote's results and the name of any dissenting director should be recorded. Each director should review all minutes to ensure that they accurately document the meeting, including the individual's participation. A director should also review minutes of any meeting not attended. If an absent director subsequently disagrees with actions taken at a meeting, the objection should be put in writing and submitted to the board for the information of the other directors and for filing in the corporate minutes book.

All documents prepared by or relating to directors and officers should be prepared with the expectation that they will be closely scrutinized in the future for evidence of wrongdoing. Imprecise wording, inflammatory or vulgar phrases, and ambiguous language should be avoided. Wording that seems innocent when written may be interpreted quite differently when considered in a different context at a later date.

Delegation of Certain Functions

Although directors may not abrogate their duties, they may rely in good faith on advice or input from board committees, officers, employees, or outside experts.

Board Committees

Board committees permit a small number of directors to perform deeper analysis of a subject that would be impractical for an entire board. Committee appointments should take into account a director's talents or expertise. Rotating directors among committees is an increasingly popular practice and may be advisable. The board should periodically evaluate what committees it should have. Common committees include executive, audit, compensation, and nominating committees. Other possibilities include planning, finance, governance, technology, conflict of interest, and social responsibility committees. The audit committee is the most scrutinized of any board committee, and at least a majority of the audit committee members should be independent directors.

Management

The board should not engage in direct management of the company. However, the board is responsible for monitoring corporate conduct by ensuring that competent management and adequate policies are in place. Key board functions include evaluating executive management (particularly the chief executive officer) and ensuring that clear decision-making procedures are in place. Officers, in turn, have similar responsibilities with respect to their subordinates. Well-defined job descriptions should be approved and then disseminated to all management personnel. The authority and responsibilities of the board and management with regard to each other should be clearly documented and understood. In addition, the board should adopt and periodically update an emergency management succession plan should members of senior management die or otherwise suddenly become unavailable.

Reliance

Directors are entitled to rely in good faith on experts, officers, committees, or agents of the corporation when making board decisions. Several guidelines should be applied when the board relies on experts:

- **Competence**—The expert should be reasonably competent and reputable in the area of advice.
- **Scope**—The advice must be within the scope of expertise.
- **Disinterest**—The expert should not have an interest or a stake in the decision the board is considering.
- **Full disclosure**—All relevant facts known to the directors should be disclosed to the expert.
- **Nature of reliance**—Directors must follow the rendered advice in good faith and with due care.

Legal Counsel

Legal counsel renders the most important risk management advice to directors. Directors should consult qualified counsel frequently. Advice of counsel not only helps guide directors toward acceptable conduct but also can improve their ability to defend their conduct when they act in reliance upon the advice. The board should not feel compelled to use the same counsel for all legal issues but should seek the most competent counsel reasonably available for the issue under consideration.

Conflict of Interest

Even the appearance of a conflict of interest should be avoided if possible and disclosed if unavoidable.

Directors and officers should avoid situations in which their personal interest may, or appears to, conflict with the best interest of the company.

This rule applies both to obvious situations, in which an individual has interests on both sides of a transaction, and to more subtle situations. If a director has a close relationship with someone dealing with the company, the director could be challenged on conflict-of-interest grounds. Because this is fertile ground for liability, directors and officers must remain sensitive toward conflict-of-interest issues. Analysis for potential conflicts should be incorporated into various corporate procedures.

When a potential conflict exists, the person involved should fully disclose to the decision makers all material information regarding the conflict and then remove herself or himself from any discussion and vote on the issue. For example, only outside directors should act on items affecting the inside directors, such as compensation arrangements and employment contracts. Having directors or officers also serving as plan fiduciaries of company employee benefit plans is another potentially dangerous conflict-of-interest situation. Inherent conflicts of interest can arise when balancing the sometimes-competing interests of the company and plan participants.

When in doubt as to whether a conflict exists, obtain advice from legal counsel.

Some Special D&O Risks

Securities Law Compliance

Many private company executives incorrectly believe that because company securities are not publicly traded, directors and officers have no liability exposure with respect to securities claims. The following summarizes some examples of securities law violations by private companies. The liability exposure for these types of securities law violations is particularly acute for companies that raise capital through the more relaxed regulatory regime created by the JOBS Act.

Public financing—Federal and state securities laws broadly define "securities" to include far more than common and preferred stock. A private company may issue debt instruments or may participate in alternative financing arrangements that constitute the sale of "securities." If those debt-related securities are syndicated or issued to a large number of participants, the private company can unintentionally become involved in a public offering of "securities." In those situations, the private company and its directors and officers must comply with federal and state securities registration requirements and ongoing reporting obligations similar to publicly held companies. Violations of any of those requirements can result in claims by regulators or the public securities holders against not only the company but also the responsible directors and officers. Therefore, companies should consult qualified legal counsel before offering or agreeing to any type of financing arrangement.

Registration exemption—Private companies with a limited number of shareholders do not need to register sales of securities with the SEC if a sale qualifies for an exemption from registration. Those exemptions are highly technical, and a failure to comply with those technicalities can result in claims against a private company and its directors and officers by regulators or shareholders who purchased shares in an offering that was neither registered nor exempt from registration.

The most common registration exemption is for "private placements" of securities. However, to qualify for that exemption, the securities must be offered to a limited number of qualified investors. Another important registration exemption, which was created pursuant to the JOBS Act, allows private companies to sell up to $50 million of unrestricted securities within a 12-month period without registering with the SEC, provided certain minimum disclosures required by the SEC are made and an offering statement and other relevant documents are filed with the SEC.

For securities offerings within at least the "private placement" exemption, private companies should, among other things:

- Prequalify all prospective investors to confirm they are sufficiently sophisticated and accredited,
- Document all pre-existing relationships and communications with prospective investors to confirm their suitability,
- Not pay selling commissions or finder's fees without a legal opinion that such payment is proper,
- Limit the resale of the securities by making a written disclosure to each purchaser prior to the sale, and
- Place a legend on all securities certificates describing the absence of registration and the applicable restrictions on resale of the securities.

Antifraud securities statutes—All securities transactions, whether registered or not, are subject to the antifraud provisions in federal and state securities laws. Any misrepresentation or omission of material facts by a private company or its directors and officers in connection with the purchase or sale of company securities can give rise to a securities claim by regulators or the damaged shareholders. Therefore, any securities transaction involving a private company or its directors and officers should be conducted very carefully with the advice and assistance of qualified legal counsel to ensure that full and accurate disclosures were made and documented. Casual sales of private company shares by the company or its directors and officers to existing or new shareholders can create the same volatile liability exposure that exists for public company directors and officers if the investors received inadequate or incorrect information when making investment decisions.

Liability exposure for misrepresentations or omissions in connection with the sale or purchase of a private company's securities increased significantly following enactment of the JOBS Act because that act allows private companies to sell securities with fewer disclosures and less regulatory oversight. In many instances, the act also allows private companies to broadly solicit investors and publicly advertise these stock sales through, for example, newspaper or Internet ads and mass mailings. These sales practices further increase the risk that purchasers will be uninformed or inappropriate investors. The safest course is not to advertise stock sales or publicly solicit investors. However, if those practices are utilized, companies should resist making overly optimistic or misleading statements in the solicitations and advertisements. The act did not amend the antifraud provisions with respect to these types of sales practices, so disgruntled shareholders can assert securities claims against a company and its directors and officers based on allegedly inaccurate or incomplete disclosures during a sales process. In essence, the act replaced pre-sale regulation of those sales with post-sale litigation as the primary method to protect investors when purchasing private company securities.

Online trading and crowdfunding—Shareholders of private companies, including employees who own company stock, are beginning to use the Internet to sell their company stock. This new phenomenon creates murky issues under the securities laws and therefore can create unexpected liability issues. Until emerging statutes, regulations, or case law better define legally permitted practices in this area, a private company and its directors and officers should not participate in, support, or promote online trading of its securities.

Under the JOBS Act and its implementing SEC rules, private companies may raise capital by seeking small sums of money from a large pool of people, often through the Internet. This practice, called crowdfunding, can create meaningful liability exposures both with respect to alleged misrepresentations to investors when the securities are sold and with respect to ongoing duties owed to a large number of shareholders. Therefore, companies should fully understand the legal requirements applicable to and the consequences of crowdfunding before deciding to use this capital-raising procedure and should exercise the same degree of care normally associated with a public stock offering.

Number of shareholders—A company becomes subject to ongoing SEC reporting requirements and is generally considered a "public" company if the number of shareholders in the company exceeds a minimum threshold. The JOBS Act increased that threshold from 500 shareholders to 2,000 shareholders. The calculation of that 2,000-shareholder threshold does not include shareholders who purchased stock through an exempt crowdfunding offering or who received stock pursuant to an employee compensation plan. As a result, a company can have thousands of shareholders and still be considered "private" for securities law purposes. Those types of private companies should strive to keep their many shareholders well-informed and should (as public companies do) operate with a view toward the best interest of all shareholders.

Shareholder derivative claims—Private company directors and officers owe fiduciary duties to all of a company's shareholders and to the company. Any disgruntled shareholder can file a shareholder derivative lawsuit on behalf of the company against the directors and officers, alleging a breach of those fiduciary duties, and can seek recovery from the directors and officers of any damages the company incurred because of those breaches. Although private companies have fewer shareholders than public companies, it takes only one disgruntled shareholder to prosecute a shareholder derivative lawsuit against the directors and officers. Therefore, private company executives should constantly seek to represent the best interests of all shareholders and to carefully discharge their fiduciary duties.

Employment Practices

Employment-related claims represent the most frequent type of claim against officers of private companies. The rules in this area are not always intuitive and are sometimes contrary to the way some companies historically would have liked to handle employment-related matters. The Chubb Group of Insurance Companies has published *Employment Practices Loss Prevention Guidelines*, which is an excellent primer for all directors and officers. You may obtain a copy through your agent or broker or by contacting the Chubb office nearest you.

Generally, senior management has two key roles in connection with employment practices liability issues:

- It must set the tone of an enlightened employer by establishing and enforcing guidelines and policies to protect against all forms of discrimination, including harassment, by retaining well-informed human resources professionals and by conducting regular educational programs designed to sensitize all supervisors to the rules that govern hiring, firing, and coexisting in today's workplace environment.
- Having set the tone, senior management must personally comply with established standards and should monitor policy compliance, authorize vigorous investigations where necessary, make accommodations where appropriate, and take meaningful remedial steps, even if senior officers are involved.

The most important deterrent to employment claims is a proactive, well-staffed, quality human resources department. The primary responsibility of that department should be to create and maintain legally sufficient and consistent practices with respect to every aspect of the employment relationship.

Foreign Transactions

Private companies that transact business in foreign countries and their directors and officers face increasing exposures for bribing foreign officials, even though that practice may be common and acceptable in the foreign country. The U.S. Foreign Corrupt Practices Act (FCPA) broadly prohibits U.S. companies (including private companies) and U.S. citizens (including directors, officers, and employees) from corruptly paying or offering to pay, directly or indirectly, money or anything of value to a foreign official to obtain or retain business from the foreign government or any other party. The number of claims and the size of penalties imposed for violating the FCPA have increased significantly in recent years.

Courts, the Department of Justice, and the SEC have broadly defined the types of activities the FCPA prohibits. For example, the statute can apply not only to business transactions with foreign government customers but also to other dealings with government officials, such as corrupt payments to obtain licenses, favorable tax treatment, or an improper advantage over competitors. The statute can also apply to payments to foreign company officials if the company is an instrumentality of a foreign country.

To reduce this exposure, private companies should create and implement effective compliance programs that continually train and educate all employees regarding prohibited conduct, monitor the effectiveness of the program, and encourage employees to report possible violations.

Lessons from Claims

The following summarizes various lessons gleaned from recent D&O liability claims.

Don't Ignore Basic Fiduciary Duties

It is tempting to think that in the confines of a private company, the basic fiduciary duties of care and loyalty can be ignored. However, the opposite is true: Because many private companies have two or more groups of shareholder constituents with conflicting desires or expectations, basic fiduciary duties do not disappear but actually become more important. Many claims against private company officers and directors involve blatant conflicts of interest, disregard of minority shareholder interests, or failure to appreciate and respond to the risks and dangers the company faces, all in breach of their fiduciary duties of loyalty and care.

Investigate Warning Signs

Usually, financial or operational warning signs are visible to senior management and directors long before a problem fully develops. Directors and officers should be vigilant in identifying those warning signs and should adequately respond on a timely basis. Significant transactions should be thoroughly investigated, and directors should continue to ask probing questions until they receive adequate answers from management.

Don't Manage to Artificial Indicators

Private companies often focus heavily on meeting internal budgets and goals. Meeting these targets can become an obsession, and personnel at all levels of the company can feel pressured to do whatever it takes to create the desired performance. Such a mind-set unduly emphasizes short-term performance and may encourage deceptive conduct.

Don’t Be Arrogant

Successful managers or dominant shareholders or executives are frequently tempted to believe they have all the answers and can ignore the input of others. Such arrogance typically leads to disaster sooner or later. Directors and officers should recognize that others may have helpful ideas, perspectives, and suggestions and may raise legitimate concerns. Senior executives should foster an atmosphere of candid and open exchange of views. They should encourage and carefully consider concerns and criticisms subordinates and directors express, and they should meaningfully respond to inquiries. Directors and officers should not surround themselves with “yes” employees and advisors who are either unwilling or unable to challenge faulty reasoning or decision making.

Maintain Reasonable Leverage

Many private companies are heavily leveraged with debt, which presents a variety of potential risks. Directors and officers should establish limitations on the amount of the debt a company can incur. Worst-case scenarios should be anticipated, and debt-related decisions should be made with a view toward various possible stress conditions.

Work With People of High Integrity

Directors and senior management should demonstrate and insist on a strong commitment to the highest level of legal, moral, and ethical conduct. A company’s culture of integrity is established primarily through the actions of its leaders. Companies should not tolerate activity that is perceived to be deceptive, manipulative, self-serving, or otherwise improper. It takes only one person’s illegal conduct to cause enormous harm to a company and to expose numerous other directors and officers to potentially dangerous litigation.

Manage Risk

Private companies should identify, evaluate, and proactively manage their most important risks rather than be reactive to predictable problems. Directors should oversee a company's risk management efforts and confirm that business decisions are aligned with approved risk tolerances.

Make No Exceptions

Many of the largest D&O liability claims arise out of relatively minor decisions or mistakes that grow over time. Some private company officers mistakenly believe that because a company does not have public shareholders, there is no need for transparency with the directors and that they can, at least temporarily, suspend good governance behavior or proper accounting practices to attain short-term results. Too often, that practice snowballs into a big problem. Avoid even the smallest departure from ethical, moral, and legal standards.

Don't Aggravate an Existing Problem

When a significant problem is identified, either internally or externally, directors and officers should promptly address the problem through a comprehensive investigation and analysis, decisive action, and forthright communications. If possible, make timely and meaningful explanations to investors, employees, customers, and other constituents regarding the source and consequences of the problem and plans to address the problem. Facts and evidence relating to the problem should be preserved for later reference, particularly if an investigation or litigation is expected or pending. In addition, directors and officers should avoid the appearance of receiving special treatment both before and after the matter is disclosed. In any event, do not deny the truth, even if the truth seems harmful.

Maximize Legal Protections

Companies should take necessary steps to provide a legal environment consistent with maximizing protection to directors and officers.

Indemnification

The internal indemnification provisions of a company should be reviewed to ensure that they provide the maximum protection permitted by law. The articles of incorporation or bylaws should require (not just permit) the company to indemnify current and former directors and officers to the full extent permitted by law. The indemnification language should also require the advancement of defense expenses, subject only to an unsecured obligation to repay the expenses if a court subsequently determines that indemnification is not permitted. If a company has subsidiaries or employee benefit plans, the indemnification provision can state that any person who serves as a director or an officer of the subsidiary or as a trustee of the employee benefit plan is serving at the request of the company, thereby obligating the parent company to indemnify those persons in those outside positions. Various other provisions relating to burden of proof, appeal, and retroactivity can be included to provide extraordinary indemnification protection for the directors and officers.

Statutory Limitation of Liability

Almost all states have laws that permit a corporation to limit or eliminate certain types of director (and in some instances officer) liability. Many of these laws require amendment of the corporation's articles or bylaws to authorize the liability restriction. The charter amendment should limit liability to the full extent permitted by state law and provide that any repeal or modification of that amendment will not adversely affect the limitation of liability otherwise applicable to any conduct occurring prior to modification.

D&O Liability Insurance

In most states, a corporation is legally permitted to indemnify its directors and officers for liabilities arising out of their corporate activities. However, corporate indemnification is not, by itself, usually considered adequate protection against liability. Indemnification may not be available to a director or an officer for the following reasons:

- The conduct of the director or officer may not satisfy the necessary standard for indemnification but may be insurable.
- The corporation may not have sufficient available cash flow to pay the losses and expenses its directors and officers incur.
- Applicable law or the corporation's internal indemnification provisions may be modified to limit or prohibit the expected indemnification.
- The composition or attitude of the board may change so that it is no longer sympathetic to a prior director or officer and will not make the findings to authorize the indemnification.
- Some claims may be insurable but not indemnifiable. For example, settlements and judgments in derivative suits are not indemnifiable in many states, but they are insurable. In addition, violations of the federal securities laws may not be indemnifiable but be insurable.

The typical D&O liability insurance policy has insuring provisions that respond in varying degrees to each of these non-indemnifiable exposures.

D&O liability insurance for private companies typically contains three distinct coverages. First, it protects directors and officers against non-indemnified loss, thereby protecting the personal assets of the directors and officers when no other financial protection is available. Second, it manages the company's potentially severe indemnification obligations by covering losses incurred by directors and officers who are indemnified by the company. Third, it covers claims against the company even if directors and officers are not also defendants in the claim. D&O liability insurance policies are unique in nature and create complex legal, underwriting, and management issues, which are difficult to identify and analyze without the assistance of knowledgeable experts.

Some aspects of private company D&O liability insurance policies that should be considered in particular follow:

- Coverage for claims against a company may significantly erode the available limits of liability for the directors and officers, so it may be advisable to limit the scope or amount of that company coverage.
- All private company D&O liability insurance policies have some type of securities exclusion, but the form of that exclusion differs greatly among policy forms. Preferably, the exclusion would apply only to the public offering, sale, or trading of company securities, not to private securities transactions.
- Some private company policies include employment practices and ERISA fiduciary liability coverage within the same limit of liability applicable to the D&O liability coverage, thereby further diluting the financial protection of the directors and officers. It may be advisable to purchase separate limits for each of those coverages.
- Key definitions should be reasonably broad. For example, some private-company policies include within the definition of "Claim" investigations, include within the definition of "Insured" advisory directors, and include within the definition of "Loss" civil penalties for an unintentional violation of law (including the FCPA).
- Many private company D&O liability insurance policies require the insurer to defend covered claims. That duty-to-defend coverage allows insureds to access the insurer's panel of prescreened and qualified defense counsel. As a result, insureds obtain not only a quality defense but also a cost-effective defense that may help preserve the policy's proceeds for other losses. Plus, that type of defense coverage affords somewhat broader insurance protection for insureds and simplifies the insured's administrative responsibilities in a claim.

Ultimately, one of the most important criteria when purchasing a D&O liability insurance policy is the selection of the insurer. Because the D&O policy affords critically important personal asset protection, the policy should be purchased from an insurer with a long, proven history of fair and responsive claims handling practices, solid financial strength, and a demonstrated commitment to this type of coverage.

Document Control

Companies should adopt a thoughtful document control program to prevent the destruction of important documents or the retention of harmful documents. A document control program should define the procedures for retaining documents relating to the corporation and actions of the board, including financial and legal documents, personnel records, and other files of the corporation. Companies should establish procedures for periodic review of documents to determine whether to retain or destroy them in conformation with state laws and evidentiary rules.

Legal Audit

Some corporations use a "legal audit" to inspect and evaluate legal structure, litigation, potential claims, and internal policies and procedures. Risk management techniques, including indemnification provisions and D&O liability insurance, can be reviewed for scope and adequacy. In addition to identifying potential problem areas, a legal audit also emphasizes to all participants the necessity for compliance with all legal requirements at all times and the importance of preventive planning.

Conclusion

Private companies have the same, if not greater, need for high-quality governance practices that public companies do. Superior corporate governance occurs only if a companywide commitment to excellence and discipline exists. Board members and senior officers must be ever mindful that their job is to serve the interests of the corporation, all shareholders, and various corporate constituencies. Executive decisions should be thoughtful, informed, made by disinterested persons, and fully documented. When appropriate, private companies should seek outside expertise.

Good corporate governance is good business. Although an investment of time, energy, and resources is necessary to achieve an exemplary corporate governance program, the tangible and intangible rewards from a successful program will far exceed that modest investment.

About the Author

Dan A. Bailey, Esq., a partner in the Columbus, Ohio, office of the Bailey Cavalieri LLC law firm, is one of the nation's foremost experts on matters relating to D&O liability, litigation, and insurance. He and his firm have represented or served as consultants to a wide variety of directors and officers, corporations, insurance companies, insurance brokers, and law firms around the country regarding D&O matters.

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