8 Reasons to Buy D&O Insurance

1. **Attracting New Directors:** D&O insurance makes board seats more attractive.

2. **Venture Capital Requirements:** Some venture capital firms require that their portfolio companies purchase D&O insurance as a condition of the firm’s investment.

3. **Emerging Risks:** The risk landscape can change rapidly. For example, risks associated with secondary sales platforms for private company stock are fairly new. D&O insurance can help mitigate some of these risks.

4. **Regulatory Exposures:** Private companies are subject to government regulation. Paying the cost of an attorney to defend an officer (or director) against a government enforcement action is expensive. Depending on the circumstances, D&O insurance policies can help with these expenses.

5. **Bankruptcy:** When a corporation is insolvent, only D&O insurance stands between creditor and/or trustee suits and the personal assets of the directors and officers.

6. **Mergers & Acquisitions:** If you’re considering M&A, it’s best to purchase D&O insurance as soon as possible (ideally before you are in discussions to be acquired.) Current directors and officers will want to be indemnified if they are sued after the deal closes. An acquiring company may be unwilling to do this. D&O insurance can provide a helpful backstop.

7. **Shareholder Lawsuits:** When a private company’s number of shareholders (without Board representation) grows, the risk that a disgruntled shareholder will file suit against the directors and officers also grows. D&O insurance is designed to respond to this risk.

8. **IPO Considerations:** If your company is considering going public, think about placing D&O insurance while still private. By doing so, you can build a relationship with public company insurers and avoid having to make any warranty statement for at least the first layer of insurance the company intends to rely on after going public.

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Choosing a Specialty Broker
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What is D&O Insurance?

D&O insurance is the insurance that responds when directors and officers of companies are sued in their capacity as directors and officers. Think of it as “malpractice” insurance for being a director or officer.

When the insurance industry discusses D&O insurance, the industry refers to the three insuring agreements in a classic D&O policy as “Side A,” “Side B,” and “Side C.”

Side A, Side B, Side C

- **Personal Protection**
  - **TRIGGER:** Actions of Ds and Os that are not indemnifiable
  - **PAYS:** On behalf of Ds and Os
  - **RETENTION:** None

- **Balance Sheet Protection**
  - **TRIGGER:** Actions of Ds and Os that are indemnifiable
  - **PAYS:** On behalf of entity (funds indemnification of Ds and Os)
  - **RETENTION:** Applies

- **C**
  - **TRIGGER:** Actions of entity for securities claims and limited other entity claims
  - **PAYS:** On behalf of entity
  - **RETENTION:** Applies

- Traditional ABC Policy strikes a balance between personal asset protection and corporate balance sheet protection
- Vast majority of companies incorporate primary ABC coverage as a means of risk transfer

Side A is the part of a D&O policy that responds when a company is unable to indemnify its directors and officers; this is referred to as the “personal protection” part of a D&O insurance contract. Side B is the part of a D&O policy that reimburses a company for its indemnification obligation to its directors and officers. Side B responds most commonly in the majority of claims brought against directors and officers in the United States. Side C of the D&O policy, also known as “entity coverage,” ensures there is corporate coverage whenever the corporation is sued along with the Ds and Os.
Stand-Alone Side A

Stand-alone Side A (also known as “A-Side”) is the type of D&O policy that only provides Side A coverage. When combined with a traditional ABC policy, it’s typical for a stand-alone Side A policy to also have what is referred to as a “Difference-in-Condition” (DIC) feature.

Many companies will structure their insurance program to include a combination of regular ABC insurance policies and Side A-only policies. This structure provides individual Ds and Os with catastrophic coverage. It also addresses the concern that, in bankruptcy, a bankruptcy trustee might attempt to seize the proceeds of a classic D&O policy since it has entity coverage. The proceeds of the separate Side A policy should, theoretically, be immune to such a seizure.

Retention: The dollar amount that must be paid by the insured before the insurance policy will respond to a loss. This is similar to a deductible.

Traditional ABC with DIC A-Side Drop Down

**DIC A-Side Policy**

- Sits excess of Clause A of a traditional ABC policy, or can drop down to replace primary A-Side coverage
- Non-rescindable
- Option to cover independent directors only (IDL)

**Coverage Triggers**

- Traditional ABC policy seized in a bankruptcy
- Refusal to Indemnify (including after M&A)
- Rescission of underlying policy
- Insolvency of underlying insurer
- When coverage terms are broader than the underlying ABC policy
Key D&O Insurance Exclusions

A policy exclusion removes the claim from the scope of the policy’s coverage. Many of these exclusions are negotiable. Here are a few key exclusions to consider in private company D&O insurance.

**Intentional fraud**

While insurance carriers will not insure for these types of D&O claims, the negotiable aspect is the point at which such conduct becomes excluded. If the conduct can only be excluded after a final adjudication of fraudulent conduct, then an insurance carrier will advance all defense costs until the final settlement is made. This is clearly better for an insured D or O than if the exclusion could be triggered earlier in time.

**Insured versus Insured**

Private company D&O insurance will not respond when directors and officers bring claims against one another. This is due to the “insured vs. insured” exclusion. However, you can negotiate some exceptions, i.e., the “carve-backs” to the exclusions. An important carve-back to negotiate is the number of years a D or O must be separated from the company before the exclusion no longer applies (for example, after 4 years, if the D or O in question sues other Ds and Os, the exclusion would not be triggered).
Structuring Your Program

For most publicly traded companies, a D&O insurance policy is rarely bundled with other lines of insurance. By contrast, private companies can purchase D&O insurance on a stand-alone basis, or can combine the D&O policy with other related lines of insurance.

- Carriers provide a single policy with options to add multiple coverage lines.

- Creates a customized comprehensive coverage program under one policy with one carrier.

- Buyers have the option to combine limits for premium savings or purchase separate limits for each coverage.

Understand Duty to Defend and Duty to Indemnify

When obtaining D&O insurance, remember that defense costs fall within a D&O insurance policy and as such erode the total limit available to pay a claim. You will want to understand if your policy is a duty to defend or duty to indemnify (sometimes referred to as a non-duty to defend) policy.
The duty-to-indemnify option means that the insured selects its own counsel, and the carrier will reimburse for defense costs. However, the carrier will only pay reasonable defense fees under the policy. The issues here is that there can be a gap between what the carrier regards as reasonable and what the insured regards as reasonable when it comes to D&O litigation.

A duty-to-defend policy has some advantages and trade-offs. One advantage is that if there’s even one covered allegation in a piece of litigation, the carrier is required to pay the defense fees relating to all the allegations brought in that piece of litigation. The trade-off in this scenario is that the carrier chooses defense counsel. This can be frustrating for some defendants who would rather choose their own counsel.
Choosing Limits

Many younger, smaller private companies will only buy $1 million to $3 million in D&O insurance—and in fact that may be all that is available to that company. As companies mature, especially as they are on the path to becoming a public company, they may start to look at purchasing $5 million to $10 million in D&O insurance.

There are several ways companies can determine an appropriate D&O insurance limit. Benchmarking is a commonly used method. Perhaps a better approach is to work through the common private company litigation scenarios, and then consult with outside counsel to understand the expected costs associated with them. Scenarios include government suits, private suits, bankruptcy and employee suits.

D&O Risks and Risk Management for Private Companies

Private companies experienced losses due to suits or fines brought by:

- Customer sues the company and/or its directors or officers for any reason other than physical injury, product failure, or impairment
- Vendor or supplier sues the company and/or its directors and officers
- Competitor sues the company and/or its directors and officers
- Government agency fines or sues the company and/or its directors and officers
- Partner or other shareholder sues the company and/or its directors and officers
- Director or officer is sued in connection with the purchase or sale of any equity or debt securities

The Risk is Real

More than 1 in 4 private companies report experiencing a D&O loss in the last 3 years

Average Reported Loss

$399,394

© Chubb, “2017 Private Company Risk Survey”, 2017

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If possible, consider ramping up your D&O insurance efforts during the D&O renewal cycle that takes place the year before your IPO. This allows you to make a few easy but strategic moves that can yield significant benefits later.

**Higher Limit Warranty Statements**

As a private company facing an IPO, consider raising your private company D&O insurance limits to between $5 million and $10 million. You would do this to avoid providing a warranty statement for your full primary (first) layer of insurance at the
time of IPO. Large insurance programs typically have multiple layers. When a company puts in place a new layer of insurance that it didn't have before, the company usually has to make a warranty statement to the insurance carrier for the new layer. The warranty statement is a representation to the insurance carrier that the directors and officers know of nothing that is likely to give rise to a claim. Of course, items that Ds and Os disclose as exceptions to a clean warranty statement will typically be excluded under the policy.

Plan Ahead: Is M&A a Possibility?
Filing an IPO often communicates a message (whether intentionally or not) that your company is for sale. And sometimes companies in fact sell themselves rather than go public. If your company is acquired, the insurance issue here is the “tail” or “run-off” policy. In general, you'll want to place a tail policy that ensures coverage exists for post-closing claims related to activity that took place pre-closing. Six years is the standard length of a D&O tail policy.

Post-closing suits can be tricky, and one never really knows if the acquirer will actually step up to provide defense costs for the Ds and Os of the acquired company, or will even be solvent a few years down the road. Also, while it's generally expected that the acquiring company will assume the indemnification obligations of the acquired company, this doesn’t always happen. Proactively placing a D&O insurance policy helps Ds and Os avoid being left vulnerable after their company has been sold.

Other Insurance
It's also important to remember that the entire insurance risk management program, and not just the D&O insurance side of things, needs to be ready for public company scrutiny post-IPO. You don't want to have gone public only to find out that your cyber liability coverage is inadequate, your international insurance placements are out of compliance, and the like. These are important items to address well before you have filed your first S-1.
Choosing a Specialty Broker

Every private company doesn’t necessarily need to purchase D&O insurance. There are some scenarios, however, where it should be a priority. If you’ve decided that your private company needs D&O insurance, what’s next?

Private company insurance carriers will need a few things from you before they will consider insuring your risk:

1. **Application** (fully completed)
2. **Financial statements** (which do not always have to be audited)
3. **Capitalization table** that lists your investors and their respective percentage ownerships
4. **Exact number of employees** by location
5. **Warranty:** Representations that your directors and officers are not aware of any current circumstances that are likely to give rise to a claim under the D&O policy

For many private companies, it’s not obvious that having a specialist place the D&O insurance is of critical importance—but this is a line of insurance that shouldn’t be placed by a generalist. The question when looking for a broker for private company D&O insurance should not be, “Do you broker D&O insurance?” Instead ask, “How much D&O insurance do you place each year, and do you use specialists for this work?”

A private company will want to avoid working with a brokerage that really doesn’t place much D&O insurance. You need someone on your team who is in the insurance market every day and knows what the latest available terms and conditions are.

You also want to work with a brokerage that places a significant number of these policies to ensure that the private company insurance carriers will pay attention to your account. There aren’t enough premium dollars in most private company insurance policies to incentivize insurance carriers to negotiate with individual private companies. This means brokerages that place a lot of D&O insurance get a lot more attention for their clients—and better insurance policies—from carriers compared to brokerages that broker fewer policies.

CONTINUED ON NEXT PAGE >
And, you may be surprised to hear that when negotiated by a skilled broker, a better-negotiated, broader policy is generally not more expensive than a poorly negotiated policy.

Finally, you don’t just want a solid D&O insurance policy; you also want any claims that arise under the policy to be paid. The chances that this will happen increase significantly when you work with a broker who has deep D&O claims management experience.

**When Should a Private Company Contact Woodruff Sawyer to be Your Specialty Broker?**

Woodruff Sawyer is a premier insurance brokerage both for public companies and for fast-growing private companies headed toward an IPO. Most of our private company clients became WS clients during their Series C or D round of funding, or within 24 months of going public. Call your Woodruff Sawyer contact or one of the authors of this *Guide to Private Company D&O Insurance* to have a conversation about whether it makes sense to consider working with Woodruff Sawyer.
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