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Five D&O trends for private companies to watch in 2021

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Following the trend set by their publicly traded peers, privately held companies continue to face elevated directors and officers liability (D&O) insurance pricing increases, which are likely to continue trending upward through 2021. Insurers are also increasingly limiting coverage terms and/or conditions. It is important to understand why the market is firming as you set new strategies with your broker partner.

Here are 5 key trends affecting the private company D&O market in 2021.

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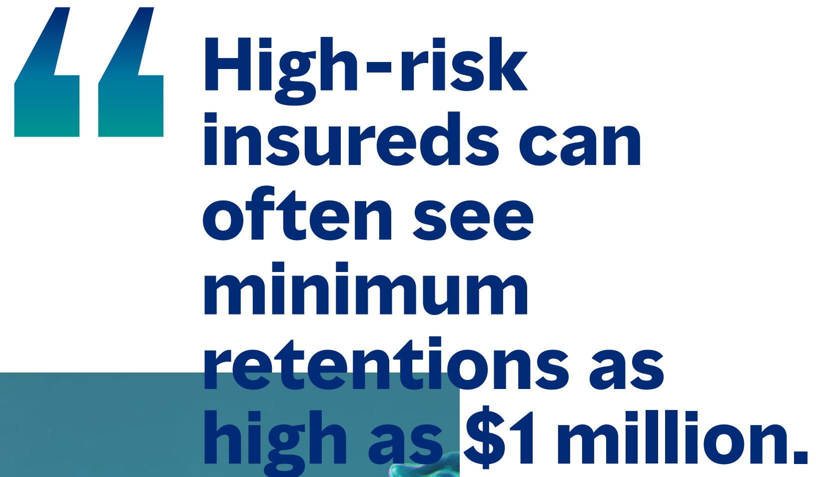

1. Evolving employment exposures

The #MeToo movement, which began in late 2017, has shone a spotlight on the widespread prevalence of sexual assaults and harassment in American workplaces and driven an increase in the frequency of employment practices liability (EPL) insurance claims and the size of plaintiffs' demands. That in turn has contributed to compressed claims resolutions timelines and larger settlement values.

Many private companies have historically purchased D&O and EPL coverage in a single policy with combined limits. This purchasing approach often allowed for aggressively discounted D&O coverage, with the bulk of the premium allocated to EPL exposures.

Given the increased demands on policy limits because of #MeToo, underwriters are now attempting to add higher, separate retentions for claims alleging sexual harassment, for claims in California — where claims frequency and severity has risen at an especially quick pace — or increased EPL retentions overall. High-risk insureds can often see minimum retentions as high a $1 million.

Some insurers are also concerned about potential mismanagement of sexual harassment by private company boards — specifically, the possibility that wrongdoing will be covered up if a perpetrator is a key executive or member of the C-suite. As a result, some insurers are seeking to add sexual battery/sexual molestation exclusions to policies, with varying intents of coverage and carve backs.

The economic fallout that followed the pandemic has further stressed employers, prompting many to lay off employees in large numbers. Layoffs oftentimes can be a basis for affected employees to make employer-related tort claims.

More than 1,750 COVID-19-related employment suits were filed through the first quarter of 2021, according to law firm Fisher Phillips. Claims from employees filed to date include allegations of discrimination and harassment against protected classes because of employee policies — including layoffs — and claims under the Americans with Disabilities Act (ADA) that employers have not been careful when questioning employees in relation to COVID-19.

Companies should have plans in place to accommodate requests from protected employee populations, such as those who are immunocompromised or of advanced age, in the event employees do not want to or cannot return to work due to health risks.

Directors and officers are also at risk of suits from employees — as well as consumers and suppliers — related to allegations of improper disclosure practices and failure to act or respond to the pandemic. Board members should educate themselves as to any potential exposure for claims related to negligence or failure to comply with best practices should an employee contract the virus upon returning to the workplace.

Growing support for the Black Lives Matter movement, meanwhile, has also sharpened underwriters' focus on diversity and inclusion practices. Employers can therefore expect more targeted scrutiny on racism, implicit bias, and related topics.

Private companies are facing shareholder and regulatory scrutiny when allegedly failing to meet promised commitments to diversity and inclusion. Parties can also sue directors and officers for breach of fiduciary duty when boards fail to monitor compliance with anti-discrimination laws. Carriers increasingly expect boards to set the tone at the top by prioritizing policies that increase diversity and inclusion.

2. M&A risks growing

Merger objection suits by shareholders are commonplace after transactions involving public companies. Private companies also face this risk, which can be exacerbated by the relative lack of transparency during the due diligence process prior to a transaction.

The recent rise in the popularity of special purpose acquisition companies (SPACs) has made acquisition targets out of many privately held firms across all industries. Significant risks exist for directors and officers in reverse merger transactions that ultimately take private companies public, commonly known as de-SPAC transactions.

For private companies engaged in these transactions, common claim types include allegations by shareholders that:

- Directors and officers breached their fiduciary duties by selling companies at undervalued prices.
- Specific executives improperly received sizable payments as a part of a transaction.
- Directors and officers of acquired companies wrongfully aided acquiring companies, resulting in inadequate sale prices.
- Representations made by directors and officers are false or incomplete, thus calling the adequacy of due diligence into question.

Generally, private company governance is not as robust as public company requirements and standards leading up to transactions. Insurers are concerned, as the costs of these claims — which are increasing in frequency — can routinely extend into seven figures. Such claims are often brought as securities suits but many private company D&O policies exclude or limit coverage for securities-related matters.

Insurers are addressing this heightened risk in two ways. First, they are increasing retentions specific to M&A-related losses. Second, they are increasing prenegotiated extended reporting period premiums charged to put an acquired company's coverage into runoff.

This process can be highly nuanced, and if not managed properly, can leave directors' and officers' personal assets exposed. It is vital that private companies work with trusted and experienced D&O advisors who can help them identify potential trouble spots and manage their risk.

3. Antitrust litigation

Merger and consolidation activity is on the rise, which raises concerns for insurers regarding anticompetitive or monopolistic behavior. Antitrust matters can also include allegations of deceptive business practices brought by competitors, violations of unfair trade practices laws as well as conspiracy amongst industry competitors (price fixing).

The Federal Trade Commission, Department of Justice, and other regulators actively enforce the Sherman Act and other antitrust laws when scrutinizing merger transactions, including deals that have long since closed with regulatory approval. Regulators are increasingly focusing on holding directors and officers accountable for their involvement in corporate wrongdoing, looking not only at individuals' direct involvement but also their alleged failures to detect and prevent misconduct within management ranks or organizations more broadly.

Potentially severe antitrust suits are a concern in many industries, but are particularly worrisome in some specific segments. These include health care; egg, milk, chicken, and ice production; television production; publishing; and manufacturing.

Insurers are responding by removing or limiting antitrust coverage in D&O policies. Those insurers that continue to provide antitrust coverage are often increasing retentions or requiring coinsurance for such claims.

When offered, antitrust coverage remains subject to exclusions for criminal misconduct if determined in a final nonappealable adjudication. Insurers typically write exclusionary language as broadly as possible to include deceptive or unfair trade practices or restraint of trade allegations brought by competitors or regulators.

Risk professionals should ensure that any antitrust exclusions contain coverage carvebacks for directors' and officers' personal assets, which is typically achievable. Carriers can also potentially carve back coverage for defense costs incurred by entities in defending antitrust claims. Insurers have often shown that they are more comfortable with antitrust risks for companies with robust corporate compliance programs.

4. Multiple risks for distressed companies

We have seen a high volume of D&O claims related to COVID-19 arising out of bankruptcy filings, the severity of which is still unknown. When private companies file for bankruptcy protection, secured and unsecured creditors often make claims of misrepresentation and breach of fiduciary duty against them and their directors and officers.

Secured creditors typically include lenders, banks, financiers, and board-represented equity holders; unsecured creditors can include vendors and equity holders without board representation. These creditors often allege that company officers:

- Engaged in deals that benefited them personally at the expense of the company.
- Improperly favored certain creditors over others.
- Improperly sold certain company assets to the detriment of the creditors seeking repayment.
- Caused a company to become insolvent through gross mismanagement.

Vendor claims, where permitted by state laws, often allege that officers knew a company was insolvent when entering into sales agreements but concealed that information from vendors. Vendors may also sue individual officers for common law fraud on essentially the same theory.

Creditors' committees, meanwhile, often make claims against distressed companies and/or their directors and officers that fraudulent dividends after recapitalization led to companies' insolvency. Liquidating trusts can also claim that directors and officers failed to take proper action when companies were approaching insolvency (commonly known as the "zone" of insolvency).

In addition to these claims, distressed companies must also contend with action by state regulators. Market downturns often prompt enforcement scrutiny because such volatility can reveal business conduct that a company would not have engaged in under normal circumstances.

In some states, for instance, regulators assign personal liability to officers of companies that fail to withhold state taxes — an especially contentious issue for web-based companies, as states often allege they have failed to withhold sales tax. State tax departments are increasingly pursuing officers of bankrupt companies for the amounts they should have paid, which can be significant.

The broad nature of the entity coverage provided in private company D&O policies makes insurers especially sensitive to insolvency risk. Insurers are thus increasingly attempting to reduce their exposure, including by increasingly using creditor and/or bankruptcy exclusions for financially distressed risks.

The appearance of these exclusions highlights the importance of standalone Side-A coverage to protect the personal assets of directors and officers. Individuals must also ensure that the non-indemnifiable coverage provided as part of larger entity programs carves back coverage for them if insurers include any sort of bankruptcy exclusion.

5. Major (principal) shareholder exclusions

Insurers have seen an influx of litigation brought by major shareholders — typically owning 5% or more voting power — when they do not have their own representation on private company boards. Marsh modeling has shown that having a significant number of owners without board representation correlates to a higher likelihood of experiencing a D&O claim.

The insurance market response to this risk has been to remove coverage for any matters brought by major shareholders if they do not have board representation. This is especially concerning to privately held companies with large valuations, as their ownership structures can be more complex.

The exclusionary language being added by insurers typically specifies that they are not liable for any claim "brought by or on behalf of individuals/entities that own (beneficially or directly) five percent (5%) or more of the outstanding stock of the insured organization."

The most preferable language for policyholders will also specify when the ownership interest is to be determined to eliminate any question at the time of a claim. The exclusion typically does not refer to past ownership but there can be uncertainty if ownership changes mid-policy term.

Companies should avoid major shareholder exclusions as much as possible, as they can preclude coverage for the very type of claims they want covered under D&O policies. Obtaining a policy without a major shareholder exclusion, however, is not always an option. An alternative is for insurers to instead increase the ownership percentage to a higher level than 5%.

A blanketed major shareholder exclusion should never be accepted, though, as it could be applied to claims brought by owners with board representation. Risk professionals should also work with brokers to ensure that any exclusions specifically name excluded owners.

Recommendations for risk professionals

Amid the current private company D&O environment, expertise, risk differentiation, and market relationships are crucial. But they are no longer the only tools needed to guide businesses through the marketplace. Risk professionals must also optimize their current insurance programs to more efficiently make use of capital.

Working with the right brokers, private company risk professionals can now access the same predictive modeling capabilities as their publicly traded peers. These advisors can use company-specific metrics in their analysis to estimate the potential likelihood and severity of D&O litigation over a five-year period.

Such projections can inform critical decisions about how to structure insurance programs. Estimates of potential claim frequency and severity can be used to analyze potential limit and retention structures to understand projected average net losses and the volatility associated with each option. This analysis can better ensure that businesses purchase the right amount of coverage and get the full value out of their D&O insurance programs.

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