CORPORATE MATTERS:
DIRECTORS AND OFFICERS INSURANCE

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Entity Formation

Many of our clients instruct us from outside the United States to establish companies through which an acquisition or some other transaction will be conducted. After completing our "know your client" obligations for a matter involving a new client, the home country advisors instruct us to form the entity and open a bank account. As mentioned in the past, we generally use Delaware as the formation jurisdiction in this type of situation.[1] Delaware law is widely known, the courts are well thought of in event of a dispute among shareholders, and corporate governance rules generally do not contain hidden traps.

Delaware requires at least one director and as part of the formation process a president, secretary, or assistant secretary is usually appointed. Typically, we are amenable to holding one or more offices as a courtesy to the client. The reason is simple. While the client may travel to the U.S. for the closing of the transaction, he or she often does not regularly stay for extended periods of time in the U.S. following the closing; therefore, it is extremely convenient for a trusted advisor to be asked to be a director or officer of the entity effecting the transaction. Depending on the type of transaction, the client (through the newly-formed entity) may have ongoing obligations – whether it be lease renewals on a purchased rental property or various reporting obligations. If the client is unable to sign documents on a timely basis, it is convenient to have a local person who can be instructed by the client to sign when and as instructed.

We have begun to see advisors insist on the purchase of insurance for risk exposure of persons acting as directors or officers, so called "D&O insurance." Although many of the formation documents typically encountered contain standard indemnity language for directors and officers, the entities involved typically grant limited liability to shareholders or members and the assets of the entity itself may not be enough to give the advisor an acceptable level of comfort. While the tasks performed by the advisor on behalf of the client may appear menial, the title the advisor holds is one typically held by senior management, and if there is to be a claim against the entity, the directors and officers are often included in the resulting litigation.

Even if the client is appointed as a director and officer of the entity, insurance may still be a good idea. Often clients, particularly those from outside of the U.S., believe that the limited number of shareholders, directors, and officers and the relatively small size of the business means there is no need for D&O insurance. It is important to remember, however, that a company's directors and officers can be held personally liable for management decisions, and if they are not indemnified by the company, a D&O liability policy will become the sole source for reimbursement.

[1] Nina Krauthamer, Kenneth Lobo, Simon Prisk, and Sheryl Shah, "Corporate Matters: Delaware or New York L.L.C.?," *Insights* 1, no. 8 (2014).

Suits against directors and officers threaten the well-being of the company as well as the personal assets of the directors and officers.

WHAT IS D&O INSURANCE?

D&O insurance is liability insurance that provides personal protection to a company's directors, managers, and officers as individuals. It is designed to protect these persons against allegations of wrongdoing brought in connection with their acting as corporate officers. D&O insurance covers actions taken that have resulted in negative financial consequences for the company. The policy will also provide coverage for defense costs. A D&O policy will not cover claims that are the result of dishonest activity and fraud or personal injury and property damage.

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D&O insurance is similar but not the same as "errors and omissions insurance." Whereas D&O insurance protects against perceived failures in the performance of management duties in connection with general oversight of the internal activities of an organization, Errors and Omissions insurance covers failures in the provision of services, and is generally applicable to those who provide the services directly to clients.

APPLICATION AND COST

To obtain D&O insurance, we work through a broker and help the client with the application process. The application will require the entity to certify compliance with the Patriot Act and all Office of Foreign Assets Control requirements. Care is needed in negotiating terms of coverage and matters like majority shareholder exclusions – where carriers seek to exclude coverage for minority shareholder claimants – should be closely examined.

Our broker described a case where the majority owner of a closely held corporation decided to take the company public and did not disclose his intentions to the minority shareholders. He hired an investment banker and was well along in the process of going public when he bought the minority owners shares for $22,000,000 and subsequently sold the shares in a public offering for $82,000,000. The minority shareholders filed suit. The cases cost $12,000,000 to settle and $5,000,000 to defend. No insurance was available due to the inclusion of a majority shareholder exclusion in the policy.

Underwriters may also want to avoid family conflicts by inserting family exclusions. The appearance of this clause will depend on the composition of the board and the decision to include can vary among insurance carriers depending on their evaluation of the risk profile.

Broad form contractual liability exclusions should also be closely examined. Although errors and omissions coverage is designed for covering third-party professional services, directors and officers are often sued on the basis of failure to supervise.

A bankruptcy exclusion works to eliminate coverage for claims filed by, for example, vendors who have extended credit to an entity and are claiming misrepresentation.

If the claim arises post-bankruptcy, the exclusion will eliminate coverage anticipated by the directors and officers.

While it is hard to give an accurate annual price for coverage – in a situation where the entity is a holding company owning real estate assets, we have found the annual cost of coverage to be in the $3,000 to $5,000 range.

For advisors acting as directors and officers, D&O insurance is also desirable from a client relationship point of view. If there is an instance where a director or officer has a claim, the claim can be made through a third-party insurance company – obviously with client involvement but perhaps without the unpleasantness of making such a claim directly to a client.