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Risk management critical for emerging nano companies

Aug. 27, 2004 - Risk management is a major issue for public companies and those on the IPO path as well private companies. Ignore it at your peril.

Emerging nanotechnology companies tend to focus on issues such as growth strategies, new product development and patent applications. Risk management is not viewed as critical for most senior nanotech managers and founders.

However, these days the subject of director and officer liabilities is discussed by every board, large and small alike.

Protecting board members

The men and women that sit on your board know that they are exposed to personal liability as a result of their actions or failing to act with respect to their duties as directors and officers. Board members want to know that their personal assets are protected should litigation and a judgment against the company take place.

State corporation laws, corporate charters and by-laws either permit or mandate corporations to indemnify their officers and directors against liabilities they may incur in carrying out their corporate duties and functions. The most efficient way to protect directors and officers is to transfer the risk to an insurance company. The product is called directors and officers (D&O) liability insurance.

Prior to the rash of recent headline accounting scandals, D&O liability insurance was sold by a host of insurers and, while not cheap, provided a great deal of value at a reasonable cost by commercial insurance standards. As the number of corporate earnings restatements began to increase, the volume of claims and the attendant legal expenses associated with the claims sent the market into a tailspin.

According to Huron Consulting, in 2002 there were 330 companies that restated earnings, a 162-percent increase from 1997. Average settlement values of shareholder class actions from 1996 to 2002 jumped from $10.6 million to $20.5 million, according to the Aon Financial Services Group.

Volatile liability insurance market This has created a highly volatile D&O liability insurance market that does not treat all companies alike. Premiums have skyrocketed, new exclusions have appeared and disputes over claims have become commonplace.

Certain industry sectors have been hit harder than others. These sectors include technology and biotechnology. Nano companies involved in healthcare and biotech will likely pay more for insurance than a nano company involved with textiles.

Private companies experienced some premium increases, but to a far lesser scale. Since the beginning of the year, the D&O market, especially for small and/or private companies, is far more competitive than in the last several years.

D&O Insurance is very specialized

D&O insurance is designed to cover directors and officers for acting within their scope and capacity. This may sound simple, but the real complexity comes with additional exclusions and other contract language that results in three out of four claims being disputed.

It is essential when considering such coverage to work with D&O insurance specialists to carefully craft policy wordings that can stand the test of claims. An organization should also have in-house D&O claims specialists with legal backgrounds to work with your company every step of the way should a claim be submitted. Care and attention to detail at the outset can save money as well as careers down the line.

Where claims come from

The source of claims for public versus private companies differs, which makes individual coverage requirements different as well. The main reason for the difference is that the insurance market has offered private companies an additional coverage called employment practices liability insurance (ELPI).

Coverage under ELPI includes claims for wrongful employee dismissal, breach of employment contract, discrimination, etc. For public companies, this coverage is usually purchased separately.

Most D&O claims arise from shareholders, employees, customers and clients, government and competitors. A 2002 study indicated that 56 percent of claims filed under D&O/EPLI private company policies come from employees.

Why buy D&O insurance?

The primary reason corporations purchase D&O are: to transfer the risk of personal loss of individuals; to attract and retain effective management and board members; to protect the corporate balance sheet and to protect corporate earnings.

Every organization should develop a strategic risk management plan and then execute that plan to achieve the tactical objectives. Communicate with your board members and legal counsel. Prepare as a team and include the treasurer and CFO.

If you are purchasing coverage, be sure to meet with your underwriters. Anticipate their questions and provide them with answers to build credibility. Do not hide bad news. Your economic interests are best served if your underwriters know you and have confidence in your management team.