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Private Real Estate Companies Ignore Directors & Officers Insurance (D&O) at Their Own Peril.

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INTRODUCTION

Many private real estate companies mistakenly believe that D&O Insurance only applies to public companies worried about the U.S. Securities and Exchange Commission. However, the complex structure of private real estate companies with the multiple parties involved make them susceptible to claims and lawsuits both as a company and sometimes as individuals with their own personal assets at risk.

In this paper, we'll review reasons why D&O insurance is a must-have for private real estate companies that work with debt and equity lenders, what the personal liability of Directors and Officers might look like, and how D&O insurance helps in the real world.

PART 1: Ten reasons why D&O insurance is a must-have for any private real estate company that works with debt and equity partners:

Today's cyber threat landscape has become Lawsuits Can Come from Many Sources: Private real estate companies face potential lawsuits from a wide range of parties beyond just partners:

Investors: If investors feel misled or their returns fall short of expectations, they may sue.

Tenants: Disgruntled tenants could sue over issues like lease agreements, property conditions, or maintenance concerns.

Lenders: In cases of loan defaults, lenders may sue to recoup their losses.

Regulators: Government agencies can sue for violations of regulations related to property management, construction, or financial reporting.

HIGH EXPOSURE TO SELF-DEALING ACCUSATIONS:

Unlike publicly traded companies, private real estate companies often act as general partners but hold minority ownership in the real estate entities. This structure opens them up to accusations of prioritizing their own interests, allocating better rates to properties they own more of, or steering lucrative deals towards themselves and not the Joint Venture.

MISMANAGEMENT OF THE PROPERTY OR VENTURE CLAIMS:

Directors and officers can be sued for alleged mismanagement, such as neglecting core responsibilities, making poor investment decisions, or failing to properly maintain properties. Even if unintentional, these actions can lead to lawsuits, increased insurance rates, loss of tenant income, and financial losses for partners and investors, triggering lawsuits.

ACCUSATIONS OF OVERCOMPENSATION:

Some disgruntled partners or investors might allege that directors and officers are overpaying themselves or their affiliates (family members, etc.) who are acting as property, construction, or development managers. This could be seen as a breach of fiduciary duty, leading to legal action.

DEFENSE COSTS:

Even frivolous lawsuits can be incredibly expensive to defend. D&O insurance helps cover the costs of lawyers and the inevitable expert witness costs from expert accountants, contractors, engineers, managers, and others.

PEACE OF MIND FOR DECISION-MAKING:

Directors and Officers are often sued in their personal capacity. The threat of personal liability can cloud judgment and hinder directors and officers from making bold, strategic decisions. D&O insurance provides peace of mind, allowing them to focus on company growth without fear of personal liability.

ATTRACTING AND RETAINING TOP TALENT:
Offering D&O insurance demonstrates a commitment to protecting your leadership team. This can be a significant advantage when attracting and retaining highly qualified directors and officers.

MAINTAINING AND RECOVERING A POSITIVE REPUTATION:
Lawsuits, even unfounded ones, can damage a company's reputation. D&O insurance can pay the costs of rehabilitating that reputation. This may involve hiring public relations firms, conducting damage control campaigns, and implementing strategies to rebuild trust with stakeholders.

COVERAGE FOR A WIDE RANGE OF CLAIMS:
D&O policies go beyond just financial mismanagement. Because it covers many of the decisions made by directors and officers, it can end up as an additional coverage source in a variety of circumstances. D&O can also be packaged together with coverage for bad employment practices, discrimination, and other professional risks, generally at a lower cost than buying those coverages separately.

COST-EFFECTIVE RISK MANAGEMENT STRATEGY:
Compared to the potential financial losses from a lawsuit, D&O insurance premiums are a relatively small expense. It's a cost-effective way to mitigate risk and protect your company's future and the individuals who run the company.

PART 2: Personal Liability of Directors and Officers:
Beyond the company's financial stability, D&O insurance offers crucial protection for directors and officers themselves. In some cases, a company may be unable or unwilling to indemnify its past or present director or officer for legal costs or settlements. This could leave them exposed to significant personal financial losses.

D&O insurance includes a section that specifically protects directors and officers in these situations. This is commonly referred to as "D&O Side A." Side A coverage pays for legal defense and potential settlements even if the company cannot or will not provide indemnification. This financial safety net allows directors and officers to make informed decisions with confidence, knowing they are protected from personal liability.

D&O COVERAGE IN ACTION:

Scenario 1: Company Forgoes Optional Safety Measures in Renovation
John, the COO of a private real estate company, spearheads a renovation project for a newly acquired apartment building. To cut costs, John decides to forgo certain optional fire safety upgrades recommended by the contractor.

Unfortunately, a fire breaks out in the building shortly after completion, causing significant damage and injuring and killing several tenants. From the investigation, it becomes public that the company and John intentionally decided against fire safety measures to save cost. Investors in the LLC that owns the building file a lawsuit against John, alleging he breached his fiduciary duty by prioritizing cost-savings over safety and causing financial losses.

Scenario 2: CFO's Alleged Self-Dealing
Company A and Company B are both real estate investors and they form Joint Venture C to buy an apartment complex together with Company A as managing member with 5% intertest and Company B as limited member with 95% interest.

Mark, CFO and Stakeholder of Company A, is suspected of intentionally allocating expenses in a way that benefits Company A and him personally. Specifically, Mark is accused of overcharging properties where he and company A have a small ownership stake and undercharging properties where they have a large stake. These actions allegedly disadvantaged the majority owner limited partners they work with, including Company B.

Company B sues Company A and Mark in his personal capacity for breach of fiduciary duty. Several other partners join the suit..

PART 3: How D&O Insurance Helps:

Defense Costs: Defending these claims can be expensive even if the allegations are meritless. The companies may be obligated to indemnify John and Mark for their legal defense in addition to defending themselves. D&O insurance can cover these costs, ensuring the company›s financial resources aren›t depleted by the costs of an expensive lawsuit.

Settlement Payment: If a lawsuit like in the examples above lead to a settlement or there's a verdict against the company or the individuals, D&O insurance can pay that cost. And having enough insurance may allow the company to settle sooner, reducing claim costs and reputational concerns.

Rebuilding Reputation: This is especially significant in John's case. Even if it's determined that (1) John's decision to forgo those safety measures was reasonable, (2) the safety measures he forwent were not customary, and (3) they would not have made a difference, the company's reputation is still severely damaged. No one wants to live in a building that is owned by a company that puts profits over the safety of children. Likewise, the John's career may never be the same. D&O insurance can include paying for firms that specialize in remediating that reputational harm.

Protecting John and Mark: The D&O insurance can cover John and Mark even if the companies cannot or will not indemnify them. It can pay legal fees and judgments that might otherwise have drained their life's savings. Both John's and Mark's careers may never be the same after this, even if they are found not liable in the end. But they may be able to avail themselves to the same reputational risk management services as the company.

Attracting and Retaining Talent: By offering D&O insurance and, therefore, being able to defend and indemnify John and Mark, the company dem.

CONCLUSION

In today's complex real estate landscape, private companies face a multitude of potential lawsuits from various parties. These lawsuits, even if unfounded, can be a significant drain on company resources and cause reputational damage. D&O insurance provides a critical and cost-effective safety net, safeguarding your company's financial health and the personal assets of your leadership team. By mitigating legal costs, protecting against personal liability, and fostering confident decision-making, D&O insurance can empower a company to focus on strategic growth and achieve long-term success. When placing D&O insurance, it's important to work with an insurance consultant or risk manager who understands the unique challenges and risks that come with real estate company structures and transactions. At Custom House, we have a team of experienced professionals who have helped countless executive teams get the coverage they need at the best possible price. ■

For more information on how D&O insurance can benefit your company, please contact the authors:

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