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Expert Analysis

D&O Insurance for IPOs: What Every Director Needs to Know

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With a potentially improving economy and rebounding public markets, the idea of going public (a long-shelved consideration in the past few years) in an initial public offering has come back in vogue, both in the United States and abroad. Going public, of course, can be a very good thing for a company, its directors, its initial investors (often venture capital firms or private equity firms) and its stockholders — if the stock does well. But sometimes the stock does not do well because the company misses earnings, or worse, finds some accounting problem that must be disclosed to investors.

The price of "not doing well" is often more than just monetary — there could be mountains of lawsuits filed against the company and its directors and officers. These lawsuits can present unique problems for defendants, since the strict liability provisions of Section 11 of the Securities Act of 1933 (which govern liability with respect to the publication of alleged materially misleading statements in a company's prospectus) are almost always implicated. That means, in sum, that *any material misrepresentation, even negligently made* (because *scienter*, or culpable knowledge, is not a requirement of a Section 11 claim), could form the basis of liability against a corporate director.

Depending upon the severity of the problem and the resulting drop in the stock price, an IPO "failure" could also draw the attention of state and federal securities regulators and potentially Justice Department. Needless to say, securities class actions and investigations can cost millions or tens of millions to litigate and settle.

The delicate balance between the "good" and the "bad" IPOs often ends up on the desk of a company's risk manager. Unfortunately, D&O insurance for IPOs is a very different product from other corporate insurance. Slips and falls, broken bones, workers' compensation, and fire losses are not the issue here. Instead, the personal assets of directors and the company's most senior executives are at risk. For this

reason, leaving D&O insurance decisions for IPOs solely to risk managers is not advised.

Directors themselves need to understand the pitfalls and perils of poor decisions related to D&O insurance for IPOs. Directors need to understand the value that a sophisticated insurance broker brings to the D&O insurance purchasing decision. This knowledge is especially important for directors in today's environment where companies may be seeking to go public under the streamlined requirements for emerging growth companies as set forth in the Jobs Act of 2012, which generally sets forth looser compliance and internal control requirements than under the Sarbanes-Oxley Act of 2002.

This article attempts to bring all of these issues together, *in one place,* for directors to understand what they need to know about D&O insurance (and related corporate insurances) when a company goes public.

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HOW MUCH D&O INSURANCE TO BUY

Very often, after a director is recruited to sit on the board of a company going public, one of his first questions is, "Well, how much D&O insurance are you going to have?" Unfortunately, there is not one right answer to this question. Some view it as a "cost question." Buying a lot of good D&O insurance costs money, and some companies don't want to pay a lot for it, as they think it's a "commodity."

Directors often take an opposite view. They are on the firing line, and if there is not enough D&O insurance, they could be asked to write a personal check to the plaintiffs' counsel to settle an action against them — a very unpalatable prospect. Finally, others view it as a question answered by reference to benchmarks — if the last company that did a $300 million IPO bought $20 million of D&O insurance, why shouldn't we?

All of these viewpoints have some ring of truth and make some sense. But the bottom line is that being uninsured is a very bad thing for everyone involved. So why not resolve to make a D&O IPO insurance purchase that makes better sense to all those potentially involved in the aftermath of a failed IPO?

To do so, consider the following: First, ask your insurance broker for recommendations as to other similarly situated companies that went public in terms of what D&O limits they purchased. A sophisticated broker with experience in the public company D&O markets should have this information at his fingertips. Such benchmarking is a good start to get a ballpark figure of what limits to buy.

Second, an arguably better approach is a market capitalization analysis of potential stock drop scenarios, using generally accepted settlement figures that are publicly available. For instance, imagine that a company expects its market capitalization 12 months post-IPO to be $1 billion. And what if that company were to suffer a 40 percent stock drop as a result of the announcement of unexpected bad news? That would equate to a $400 million market capitalization drop.

Taking 10 percent of that number (10 per-cent being a "proxy" for the percent of shareholder losses that might be recoverable in a "medium" severity case) would equate to a potential settlement of $40 million (but note that in a Section 11 case with strict liability issues, the settlement percentage could arguably be higher!).

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Adding in attorney fees and the potential costs of an investigation might get you to a $50 million total per-claim loss. The $50 million number should be another data point to consider when evaluating a D&O limits purchase. Again, there is no "right" answer here.

WHAT CARRIERS TO USE IN THE 'TOWER'

Years of experience defending against securities class actions allow me to make some comments about the importance of good D&O insurance. D&O insurance is not a commodity. Not all D&O carriers are equal. Not all D&O carriers have good reputations for handling and paying claims. Not all carriers will "step up to the plate" when it's time to resolve the action.

Directors should ask around (to other directors and other companies of boards they sit on) to understand which carriers are willing to pay claims and which are not. Good brokers will have this information too, if they are willing to share it with you.

Lawyers who defend against securities class actions typically run into many carriers while mediating class actions and may also have an opinion on which carriers are business-minded and stand behind their director clients. There is nothing worse than having a recalcitrant carrier at the settlement table that refuses to pay a claim.

PORTFOLIO COMPANY IPOS VS. SPIN-OFFS

Many times IPOs are a tool for private equity firms or hedge funds looking to exit or reduce an investment. Sometimes IPOs result from larger companies spinning off profitable subsidiaries into stand-alone public companies. Spin-offs present unique challenges to consider in the D&O insurance purchasing decision:

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- The potential for overlapping boards.
- The potential for a stock drop for not only the company going public, but for the parent as well under certain circumstances.
- Counsel and privilege issues that might require multiple sets of defense counsel (which add to the cost of a litigation).
- The selling shareholder liability of the ultimate parent that is selling its shares of the spin-off in the IPO.

Regardless of the challenges, one simple strategy for a director of the company going public is to insist that the company purchase enough D&O insurance to fully satisfy the company's (and his) potential liability to shareholders. Another question to ask is whether there will be any additional insureds on the policy (such as the private equity sponsor or the ultimate parent that is spinning off the company going public) who may have other liability issues like potential selling shareholder liability. If too many constituencies share from the same tower, chances are that there may be not enough money left at the end of the day to effectuate a settlement of all outstanding litigation and investigations, especially in a Section 11 case.

INDEMNIFIABLE VS. NON-INDEMNIFIABLE LOSS COVERAGE

Part of any analysis of the purchase of D&O insurance is the purchase of "Side A" D&O coverage. Side A excess D&O coverage is for "non-indemnifiable loss," *i.e.*, loss incurred by a director for which a company cannot advance or indemnify or is financially unable (because of an insolvency scenario) to advance or indemnify

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pursuant to its bylaws or certificate of incorporation. Side A coverage only exists for the benefit of the directors and officers — it would never cover the entity.

Though certainly a part of traditional D&O coverage, in the years after Enron and Worldcom, it has become standard to purchase separate Side A D&O coverage to cover the directors and officers with dedicated limits that are fully accessible in any insolvency situation.

Though some would term this "bankruptcy-specific" D&O coverage, the need for Side A excess D&O insurance can come up in other ways. More specifically, under Delaware law, the settlement of a shareholder derivative action is "non-indemnifiable," meaning the company cannot fund such a settlement. So having Side A coverage available for such a situation is a huge positive for a director.

More specialized forms of Side A coverage also exist, like Side A "difference in conditions" coverage (which can, under certain circumstances, drop down and provide coverage in situations where an underlying carrier won't pay) and "independent director" coverage (which expressly covers only independent directors). Directors and independent directors should insist on dedicated Side A limits as part of the overall IPO D&O structure.

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MANDATORY ADVANCEMENT: PRESUMPTIVE INDEMNIFICATION CLAUSES

One of the new developments in the D&O marketplace over the last two years is mandatory advancement of defense costs under any circumstance. Before 2010 D&O carriers would generally advance defense costs from dollar one in insolvency settings, understanding that in such a case a company "was unable to advance" defense costs within the retention and that to not advance defense costs would potentially leave directors without adequate counsel, thus exposing them (and the carrier) to increased exposure.

A soft market for D&O insurance, among other reasons, caused carriers to expand advancement of defense costs to situations where a company "simply refuses" to advance or pay a director's defense costs, in addition to the insolvency scenario. That is a huge consideration when such defense costs could run into the hundreds of thousands of dollars.

Further, presumptive indemnification language normally contained in D&O policies should be stricken or watered down so it does not conflict with the broad advancement of defense cost coverage now being offered in the D&O marketplace.

DEFINITION OF LOSS ISSUES

A D&O policy is not particularly useful if it does not cover all claims-related payments and settlements concerning litigation commenced against directors and officers. A director should insist on the broadest definition of "loss" possible, which should include the payment of:

- All pre-claim investigation or inquiry costs.
- All defense costs, judgments and settlements related to litigation and post-claim investigatory proceedings and litigation.
- All expert costs.

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- Any defense costs associated with bankruptcy-related investigations commenced by a trustee, receiver or creditors committee.
- All defense costs and settlements associated with claims against the director under Sections 11, 12 and 15 of the 1933 Act.

BANKRUPTCY PROTECTIONS

Needless to say, the primary D&O policy should work in all settings, including bankruptcy settings. Directors should insist on broad "definition of claim" words to cover bankruptcy investigations and a broad carve-out from the insured-vs.-insured exclusion for derivative claims brought by creditors committees, bondholder committees or properly formed bankruptcy constituencies of the company.

Finally, get a simplified "order of payments" (or "priority of payments") clause that does not leave any discretion to the company to withhold or direct payments under a D&O policy.

CONCLUSIONS

Though the list of questions is long, it is certainly not exclusive of other D&O policy enhancements sophisticated brokers might also suggest for clients going public. A good broker can be an ally here, not a hindrance to the process.

At the end of the day, however, it is up to individual directors to fully educate themselves on the D&O coverage for any company for which they are going to sit on the board. This is an area that is simply too important to overlook. Again, good D&O insurance often goes unnoticed. But poor D&O insurance often comes to light at the worst possible time for a director.

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