

Taking Your Investment Public: Addressing Executive Exposures Arising From an IPO

In light of the overall performance of the major indices in 2009, the total volume of Initial Public Offerings (“IPO”) remained below historical levels experienced in prior years. However, if IPOs are any indication of economy’s overall health, then perhaps we should be more optimistic about economic prospects in 2010. The IPO market recovered during the second half of 2009 as 49 of the year’s 63 IPO’s took place during that period.¹ Whatever your firm’s reasons are for pursuing an IPO in 2010—whether you are a private equity firm seeking to exit an investment or a privately held concern looking to raise capital to expand or reduce debt levels—failure to properly address management liability insurance could potentially wipe out any proceeds gained through such an endeavor and could implicate the personal assets of directors and officers.

Going forward, as IPO’s become a more frequent and viable avenue to raise additional capital, companies will begin to analyze a number of criteria to determine if this option is indeed a suitable vehicle for their future. Once a company elects to undergo the IPO process, material and new risk exposures arise. To illustrate, the average public company has a 6.4% chance of encountering a securities class action over a five year period, with a far greater likelihood of the event occurring within three years of offering date.² Class actions typically settle in the eight figure range exclusive of costly securities defense firm legal fees. The distinction between covered versus non covered claims under an insurance policy is often substantial and the proper engagement of a specialized management liability insurance broker is critical to ensure that a comprehensive risk management tool is in place to respond to the additional exposures associated with an IPO.

D&O INSURANCE CONCERNS

Directors and Officers Liability (“D&O”) insurance policies are the most common vehicle to transfer executive liability risk. D&O policies are underwritten to address the inherent risks faced by directors and officers who assume certain fiduciary duties in serving on a Board or senior management position. While many privately held companies maintain a D&O insurance policy that provides protection specifically designed for that corporate structure, that policy will not address the myriad of new exposures that a company faces once it embarks on a public issuance.

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Proper negotiation from the private form to the public one becomes a crucial component of securing the proper coverage. Most importantly is the need to fully address and insure the risk from litigation brought against the directors and officers of public companies arising from wrongful acts relating to the Securities Act of 1933 and the Securities Exchange Act of 1934. Commonly, private company D&O insurance policies exclude claims involving the issuance of securities. This restriction is obviously not incorporated within a public company D&O policy form.

PRE-IPO EXPOSURES

The risks inherent with going public commence well before the first day of trading. Although exposures and financial impact vary, the potential to experience a situation which may give rise to a claim begins early in the process. Even

in the pre-public stage of the cycle, a company board must satisfy its fiduciary and related duties that can be enhanced and magnified as consideration of a public filing emerges.

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Once the process begins, the road show presentation and concerns over representations made to audiences of potential investors further heightens the possibility that a company or its board of directors will encounter a claim. Further potential liability attaches under SEC regulations with respect to the S-1 and other filings. In some instances, companies ultimately decide to postpone or cancel their IPO. This can also generate claims from existing investors. Needless to say, timing does not inure to the company's benefit in the sense that companies attempting to go public have little time or funds to dedicate towards defending a lawsuit.

All this leads us to the discussion of insurance, and again, the importance of having a properly drafted policy in force at the right time. For private company D&O buyers who consider an IPO, the private company form itself can be endorsed to include a "Road Show" endorsement that will extend the private company policy to cover the pre-IPO exposures discussed above. For those companies who do not maintain a private company policy pre IPO, the need to incept a D&O policy at an early stage is vital to securing coverage for any and all claim events that either precedes the IPO date or takes place after trading begins. In some instances, a lawsuit may allege certain pre- and post-IPO wrongful acts. In such scenarios, full coverage could only be secured by having the insurance in place throughout the timeline of events that are the substance of the claim.

POST-IPO EXPOSURES

Once the IPO has been successfully launched, the company is now subject to the oversight of the SEC including any investigations they may commence and all costs associated thereto. Although subject to a fair degree of reform over the

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years, the SEC contains a number of statutes that maintains a fairly liberal approach to preliminary pleading thresholds. Under the Securities Act of 1933, key exposures exist for issues such as adequate financial and operational disclosures and registration matters. Once a company is publicly traded, the Securities Exchange Act of 1934 and its broad liability imposing

statutes is applicable. The most prominent among these statutes is Rule 10(b)-5 which is intended as a "catch all" provision for any alleged deception or fraud. Not surprisingly, Rule 10(b)-5 is the most common and costly to litigate. Accusations of insider trading, corporate misstatements and corporate mismanagement generally derive from alleged violations of this particular provision.

In addition to the 1933 and 1934 acts, the Sarbanes Oxley Act of 2002 has increased scrutiny on all publicly traded companies. As a result, directors, officers, and signors of publicly filed documents face greater exposure to risk. Due to these risks, companies that have successfully reached this stage must unfortunately face a heightened risk of claim activity. The facts below illustrate this increased exposure basis:

- Most securities claims are filed within three years of the IPO and there is a significantly higher probability that a class action lawsuit will arise when an IPO is involved.
- About 20% of all securities class action claim activity involves an IPO.
- In the first half of 2009, the average settlement for a class action was \$43 million, exclusive of defense costs³.
- For the full year 2008, class action filings were at their highest level since 2002 with 259 claims; however, in 2009, filings fell to 169⁴.
- Nearly 70% of all securities class action claims filed in 2009 were *not* directly related to the credit crisis⁵.

STRUCTURE

Through the years, a number of litigation trends and macro-economic events have resulted in several available structural alternatives for a public company D&O insurance policy. The vast sources of claims against publicly traded companies have given rise to multi-faceted structures potentially involving multiple insurers and policy types. Standard policies include three key components of coverage: Non-Indemnifiable Loss ("Side-A"); Indemnifiable Loss ("Side-B"); and Corporate Entity Coverage for Securities Claims ("Side-C"). Each insuring agreement is designed to protect the firm and its directors and officers from different exposures; however, it is important to consider how each of these insuring agreements impacts the overall availability of coverage for each insured. For example, since the advent of D&O

insurance, insurers have extended the contracts to provide coverage for the entity, in addition to the individual directors and officers, to protect the Company's balance sheet against securities claims. Since the policy will maintain one aggregate limit of liability, some individual directors and officers may not be entirely comfortable sharing the limit with the entity. In this case, policy holders may wish to either purchase additional (excess) policies or a dedicated Side-A Only insurance policy. Another structural option is simply not to grant coverage to the entity itself. Prior to selecting a program design for your D&O tower, we recommend taking the time with your broker to fully understand the available options to identify the structure that best satisfies the Company's risk management philosophy and the concerns of its directors and officers.

Concerns regarding the total appropriate limit for any one organization are one of the most important structural issues. These questions should be addressed utilizing a full analysis of market capitalization, industry sector, and other unique criteria. A management liability specialist will be able to provide answers to these questions to help the policyholder derive at an appropriate limit of liability for their risk profile.

Under private company policies, D&O and Employment Practices Liability (EPL) coverage are bundled under one policy form and generally subject to a shared Limit of Liability. EPL coverage is most frequently utilized to protect the company and its employees from non-injury related employment/workplace claims. Due to the increased frequency of D&O claims filed against publicly traded companies, these entities almost exclusively purchase separate, and stand-alone, D&O insurance programs to insulate the available coverage for both exposures. Another key difference in the public company policy form is the self-insured retention. Underwriters of private company D&O policies grant coverage subject to a relatively small retention level. For public company D&O policies, the carriers will likely utilize a significantly larger deductible to more appropriately align with the risk from a securities claim. To address EPL exposures, a separate policy should be incepted at the time of the IPO.

In connection with the above, and often times most important, is price. Most buyers have a finite ability to dedicate resources towards insurance during this volatile time in the company's history. Again, a management liability expert will be keenly aware of which insurers favor a particular risk and will be able to have relationships with

the full array of carriers so as to create a competitive submission and marketing effort.

UNDERWRITING TIMELINE

In order to place a truly comprehensive and cost-effective D&O program underwritten by financially sound insurers, the Company should begin working with the broker prior to the S-1 drafting period. If a D&O policy is in place already, it should be amended to include coverage for the ensuing road show; if a policy is not in effect, it should be placed immediately with the aforementioned coverage extension. Then once the S-1 has been filed with the SEC, the submission will then be provided to the underwriters for their review. While the SEC is reviewing the document and preparing their comments, the broker will assess each carrier's appetite for the risk. **The Company should begin working with the broker prior to the S-1 drafting period.** Some of the factors underwriters will gauge within the Company's unique risk profile include: business sector; board composition; financial condition; and, use of proceeds. Based on these criteria, the broker will be able to identify which insurers are most comfortable with underwriting the D&O policy through the IPO. Once an amended S-1 has been submitted to the SEC, the insurance underwriters will again review the materials. The broker will then narrow the field of carriers that will ultimately write the insurance policy. Currently the public company D&O arena includes more than 25 qualified insurers maintaining a minimum AM Best rating of "A-". In addition to scope of coverage, cost, and financial rating of the insurers, it is imperative to review each carriers experience underwriting D&O policies for IPO transactions, claims handling capabilities, and history within that industry segment. Next, the Company will meet with the selected D&O underwriting community to assuage any remaining concerns of the carriers. When final proposals have been negotiated with the insurers, the broker will examine each indication with the Company to identify the most appropriate insurance solution for the risk. In the end, the broker will incept the desired program shortly prior to the offering date to ensure that coverage is available to cover all past acts and actions associated with the offering.

ABOUT FRANK CRYSTAL & COMPANY

As the alternative in insurance brokerage, Frank Crystal & Company provides industry-leading insurance services, solutions, and counsel to corporations as well as individuals. The company provides a highly consultative approach. Leveraging its insurance advisory, claims management, risk control engineering, and administrative expertise to the benefit of its clients.

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