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What Do an IPO, a Summer Vacation, and D&O Coverage Have in Common?

By Christopher Duca

Summertime is upon us and long weekends at the beach or lake are favorite getaway destinations for fun with friends and family. As I checked the family vehicle in anticipation of a long trip I determined that the air pressure in the tires, the oil and fluid levels were all fine, and most importantly the DVD player was working. One mile into the journey, I realized that we would need to stop to fill up the gas tank as the gauge read empty. On the way I commented to my lovely wife how expensive gasoline prices are and that filling up the tank was likely to cost $70. My perspicacious 10 year old daughter, who just mastered fractions in math class and wanted to help, informed me that we could save money by only buying half a tank of gasoline. While a half tank of gasoline costs less than a full tank of gasoline and is probably a sufficient amount of fuel to reach our destination, a full tank just feels better when driving a long distance. Needless to say we filled the tank and the weekend trip was enjoyable without any need to stop again to refuel. In life many of our best decisions are made based upon feel or your gut. With life’s many decisions I feel confident I made the right one in this instance. If only all decisions were that easy.

And while we would like to live in an environment where all credible data and information are readily available to help us make informed decisions, we are operating with unprecedented uncertainty and are forced to make decisions in shorter periods of time. However, with periods of uncertainty there is often significant opportunity. One of the more efficient methods to monetize an opportunity is through the capital markets. The initial public offering (IPO)

market in the U.S. is heating up and is on track to mint the highest number of new issues in five years. The total number of filings through May of 2006 topped 106 IPOs with over 30 filings in the most recent month alone.

Companies that file securities with the U.S. Securities and Exchange Commission (SEC) are primarily subject to the federal securities laws that include the Securities Act of 1933, as amended (the 1933 Act), and the Securities Exchange Act of 1934, as amended (the 1934 Act). Under Sections 11 and 12 of the 1933 Act, every person who signed the registration statement or who was a director of the company at the time of filing of the IPO, subject to certain statutory exceptions, has civil liability for any part of the registration statement or prospectus that contains an untrue statement of a material fact or omission of a material fact that is required to avoid misleading statements.

After a company files for an IPO the issuer typically purchases for the first time a directors' and officers' (D&O) liability insurance policy. While many privately held companies, particularly those backed by venture capital, purchase a D&O liability insurance policy, most do not. One study by Chalmers, Dann, and Harford featured in *The Journal of Finance* (April 2002) found that 97.2 percent of companies going public purchased a D&O liability insurance policy within five days of the IPO's effective date. While 85 percent of the sample companies had not previously paid D&O premiums prior to going public, for 92 percent of the companies the effective date of the D&O liability insurance policy was one day prior to the IPO prospectus effective date. This difference in purchase pattern percentages reflects the fact that most privately held companies' D&O liability insurance policies are canceled and re-written to coincide with the IPO prospectus effective date. The study also found that the D&O liability insurance policy premium pricing did not vary significantly in the middle 8 of 10 decile IPO categories. The average rate per million dollars of coverage for a D&O liability insurance program in the study was $40,000, while the median rate per million was $38,000. The lowest decile and highest decile varied significantly, with the pricing for a rate per million dollars of D&O liability insurance coverage equal to $25,000 and $61,000, respectively.

Another study by Lowry and Shu (2001) reported in *The Journal of Finance* (April 2002) article found that 5.76 percent of issuers of IPOs are sued by their shareholders in a class action alleging violations of the 1933 Act and the 1934 Act. This translates into a 65% higher frequency rate of securities class action filings based upon the study's findings for an IPO as compared to the rate of such filings for the average publicly traded company. This trend toward heightened frequency rates for IPO class actions seems to be continuing. A recent case on point: on June 2nd, 2006, a securities class action lawsuit was filed against Vonage Holdings Corporation and its officers for allegedly violating federal securities laws involving its IPO dated May 24, 2006.

Today the legal environment is particularly challenging as litigation frequency is high and severity is increasing in the era of mega-securities class action settlements. On May 9, 2006, SEC Commissioner Roel C. Campos stated, “Still, the environment feels more dangerous, and directors certainly are concerned about being dragged into lawsuits spending their valuable time and resources to defend themselves, even if they are ultimately found not to be culpable.”

Why does a company that files for an IPO purchase a D&O liability insurance policy? Generally, a D&O liability insurance policy provides security and certainty to directors and officers of a company that files for an IPO by providing protection for covered loss from a securities class action lawsuit. The insuring agreements, which are subject to all terms and conditions of the entire policy, define the covered loss of the policy for alleged violations of Sections 11 and 12 of the 1933 Act, the 1934 Act, the Sarbanes-Oxley Act of 2002, any similar state securities laws, and administrative actions brought by the SEC or any similar state regulatory agency.

D&O liability insurance policies do not provide coverage for the insureds where there is culpability or actual fraud, ill-gotten gains, disgorgement, restitutionary damages or “restitutionary in nature” settlements. A factual record as to whether there is any culpability which precludes coverage through the policy or brings into question insurability under the law or public policy develops through the adjudication process. In the matter of a private securities litigation,

Section 27 (7) (E) of the 1933 Act provides for Reasons for Settlement. This provision of the 1933 Act permits the parties to provide a brief statement explaining the reasons the parties are proposing settlement. If the reasons for settlement document fraud, ill-gotten gains, restitutionary damages, a “restitutionary in nature” settlement, or disgorgement then the settlement is not a covered loss under the D&O liability insurance policy. Section 27 (7) (F) of the 1933 Act provides for Other Information. This provision permits the court to provide other information that may be helpful in determining the insurability of the settlement. Therefore, all court approved settlements of securities class action lawsuits that alleged violations of Sections 11 or 12 of the 1933 Act when originally filed do not necessarily equate to a finding of fraud, ill-gotten gains, restitutionary damages, a “restitutionary in nature” settlement, or disgorgement.

Even with these provisions in the 1933 Act that enable the parties to clarify the elements of a court-approved settlement, not all D&O liability insurance policies are the same. Some D&O liability policies only provide coverage for IPO claims for the portion of the securities class action lawsuit that relate to the 1934 Act and may limit coverage for defense costs only or provide no coverage for the 1933 Act. Purchasing a D&O liability policy with express coverage for only one of the two major federal securities laws is similar to leaving for a summertime vacation with the gasoline tank half full. Arrival to

the destination may be without any complications, but the journey may be uneasy. The lack of express coverage for the 1933 Act leaves a director facing the significant potential for uninsured personal liability for merely alleged violations of Section 11 or 12 of the 1933 Act.

Many current Form S-1 filings with the SEC contain an IPO Risk Factor section which includes a disclosure warning to investors that "the company may incur higher costs to obtain directors' and officers' liability insurance coverage in order to attract qualified directors." This is a valid prospectus risk factor as many prospective directors of IPO companies are requesting higher D&O limits of liability with the broadest coverage available. And while rates for the overall D&O liability insurance market are stabilizing, D&O pricing for IPOs is expected to increase approximately 25% in 2006 due to the increased frequency and severity of securities class action exposure coupled with higher demand for quality coverage.

In the *Journal of Economic Theory* article entitled "Increase in Risk and Risk Aversion", economists Diamond and Stiglitz closely linked increases in risk and risk aversion. For those who are risk averse, an increase in risk will to a degree increase risk aversion. Therefore, buyers of insurance products purchase with the objective of converting unknown costs to a predictable stream of insurance premiums. The result is a reduction in risk. In the *Journal of Economic Theory* article entitled "On the Theory of Risk Aversion", economists Menezes and Hanson found that the more risk averse a firm is the more likely it is to accept insurance premium price increases.

Insurance buyers who value coverage over price when making a decision to buy D&O liability insurance should strongly consider a D&O liability insurance policy that specifically provides covered loss for both the 1933 Act and the 1934 Act. This line of thinking could be described as leaving for a summer vacation with a full tank of gasoline. The cost is higher at the start, the journey may not be uneventful, but you are in a better position to enjoy the road ahead.

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