THE INITIAL PUBLIC OFFERING

A Guidebook for Executives and Boards of Directors

Third Edition

PATRICK J. SCHULTHEIS
ROBERT G. DAY
J. RANDALL LEWIS
SHAWN J. LINDQUIST
ROBERT G. O'CONNOR

WILSON SONSINI GOODRICH & ROSATI, PROFESSIONAL CORPORATION

BOWNE

Chapter 4[†]

D&O Liability Insurance

Directors and officers of companies face the possibility that — even if they diligently discharge their duties to their stockholders — their stockholders may still sue them. During the period leading up to an IPO, directors and officers may be particularly concerned about their personal liability because the chance that they will be sued by their stockholders substantially increases once the company's shares are publicly traded. Recognizing that the risk of personal liability makes being a director or officer of a public company unattractive, most companies purchase director and officer liability insurance, or "D&O insurance", to protect their directors and officers. This insurance can in turn help companies recruit and retain good directors and officers.

The Need for D&O Liability Insurance

D&O liability insurance is best understood as a type of professional liability insurance for errors and omissions that a company carries to protect its directors and officers if they are sued. It is D&O insurance that responds when directors and officers are accused in civil or criminal court of acting in a way that violates their duties to the stockholders or the law, especially federal securities law. From a dollars perspective, the largest threat that public company directors and officers face is the threat of a federal securities class action suit that alleges violations of the federal securities laws. This type of suit is most likely to occur when there is a precipitous decline in a company's stock price. Since the passage of the Securities Litigation Reform Act in 1995, the average stock price drop suffered by companies with resulting federal shareholder class action lawsuits has been 39%.

These lawsuits are of great concern for directors and officers because the trend in average cash settlements has been upward. The average cash settlement in 2007 was $27.9 million, compared to only $8.3 million in 1997. Moreover, the directors and officers of companies that are sued shortly after a company goes public are at particular risk because these lawsuits generally include allegations of having violated Section 11 of the Securities Act. Such cases are relatively easier for plaintiffs to pursue because the pleading standards under Section 11 are easier for plaintiffs to satisfy as compared to other civil liability provisions of the federal securities laws. (Section 11 is

---

[†] The authors wish to thank Priya Cherian Huskins for preparing this chapter. Priya was an associate at Wilson Sonsini Goodrich & Rosati from 1997 to 2003. Priya is a Partner and Senior Vice President of Woodruff-Sawyer & Co., a commercial insurance brokerage. Priya specializes in D&O liability risk and its mitigation, including D&O insurance. The authors also wish to thank Woodruff-Sawyer & Co. for making their database available for use in preparing this chapter.

discussed in greater detail in Chapter 7.) Another reason these lawsuits are of great concern to directors and officers is that they often take years to settle, resulting in legal defense fees in the millions of dollars.

Beyond securities class action lawsuits, directors and officers should be concerned about suits that allege that they breached their fiduciary duties to a corporation. These suits can either be brought directly or derivatively. Derivative suits are of particular concern because, in some circumstances, a company cannot indemnify its directors and officers to settle these suits, leaving insurance as the only payment source available to a director and officer other than his or her own checkbook. In these suits, the stockholder alleges that the officers and directors who are the subject of the suit have breached a fiduciary duty owed to the company and its stockholders and must pay damages or make restitution to the company. In recent years, more than 50% of all securities class action law suits have been accompanied by "tag along" derivative suits that were premised on the same alleged wrongdoings recited in the securities class action complaint. Moreover, there is reason to be concerned that the plaintiffs' bar has increasingly used derivative suits in bringing claims. For example, in 2006 derivative suits — and not securities class action suits — were the primary vehicle stockholders and plaintiffs' firms chose for pursuing claims related to stock-option backdating. Like federal securities class action lawsuits, these suits can be extremely expensive for a company to defend.

In most cases, companies have an obligation to indemnify their directors and officers for suits brought against them. This obligation can arise pursuant to personal indemnification agreements as well as provisions found in a company's charter documents, and sometimes pursuant to state law. Nevertheless, directors and officers usually require the company to purchase D&O insurance as a form of balance sheet protection for this indemnification obligation and to protect themselves if, during the midst of a long-running lawsuit, their company becomes financially or legally unable to indemnify them.

Outline of a D&O Insurance Policy

Although a D&O policy can be described in broad terms for heuristic purposes, it bears mentioning that a particular company's D&O insurance program is typically comprised of several highly negotiated financial instruments. Most public companies purchase their overall limits of insurance from multiple insurance carriers in layers. Each of these layers represents coverage provided by a particular insurance carrier for

typically at least $5 million in limits and often much more. The terms of each of these layers of insurance is set by the insurance policy issued by the insurance carrier providing that particular layer of insurance. Each of these layers must be separately negotiated by a company's insurance broker. This process generally includes negotiating multiple endorsements, *i.e.* amendments, to an insurance carriers' basic policy form.

Typical D&O Insurance Policy. A typical D&O insurance policy is divided into three parts, all of which share the same single policy limit put up by the insurance carrier. "Side A" is that part of a D&O insurance policy that responds when a company is unable to indemnify its directors and officers. The most common example of such a situation is when a company becomes insolvent. Properly constructed, this part of the insurance policy should pay on a first-dollar basis, *i.e.* there should be no self-insured retention or deductible. Side A coverage is often referred to as the "personal protection" part of a D&O insurance contract.

"Side B" is that part of a D&O policy that reimburses a company for its indemnification obligation to its directors and officers. This is typically the case with the vast majority of civil claims brought against directors and officers. This part of the insurance policy is generally subject to a self-insured retention or deductible.

"Side C" – also known as "Entity Coverage"– is that part of a D&O policy that responds to securities claims made against the company. Side C exists because in a typical federal securities class action lawsuit, the company is a named defendant along with the directors and officers. If an insurance policy does not have Side C coverage, the insurance carrier and the company must negotiate the portion of the total defense costs and the settlement of a securities claim that is to be allocated to the uninsured company and the portion that is to be allocated to the insured directors and officers. This will be a contentious negotiation because any portion of the suit that is allocated to a company without Side C coverage is a portion the insurance carrier does not have to pay. Purchasing Side C coverage eliminates this area of dispute. Like Side B, Side C is typically subject to a self-insured retention or deductible. Side B and Side C coverage together are often referred to as "balance sheet protection" for a company.

Side A Difference in Condition D&O Policy. A Side A "Difference-in-Condition" or "DIC" policy is a D&O policy that only provides Side A coverage. Such a policy does not include Side B and Side C coverage. Many companies will structure their insurance program to include a combination of regular ABC insurance policies and Side A-only insurance

policies. One of the main drivers of this type of insurance program structure is the concern that directors and officers with only a full ABC policy may find themselves without any insurance coverage if their company ends up in bankruptcy, which is, of course, precisely the moment that the company can no longer indemnify its directors and officers. This concern arises because there is some risk that if a company goes into bankruptcy with a D&O policy that includes Side C coverage and perhaps Side B coverage, a bankruptcy trustee may attempt to seize the insurance policy proceeds for the bankruptcy estate. Such a seizure would leave the directors and officers without coverage unless they had a separate, Side A policy on which they could rely. While many courts have declined the invitation to appropriate D&O policy proceeds to the bankruptcy estate, legal experts agree that there is a higher probability that that a bankruptcy judge would allow a bankruptcy trustee to seize all the proceeds of an insurance policy if the policy includes balance sheet protection. The bankruptcy trustee's argument is that the now-bankrupt company paid for the insurance policy and is the intended beneficiary of the policy by virtue of being an insured party under the policy. Therefore, the insurance policy may be viewed by the bankruptcy court as an asset of the now-bankrupt company and not exclusively as an asset of the directors and officers. A bankruptcy trustee would not have this same argument to seize the proceeds of a Side A policy since the company is not an intended beneficiary of a Side A policy; the only intended beneficiaries of a Side A policy are the company's individual directors and officers.

Typically, bankruptcy is not a concern for a company that is about to embark upon an IPO. Thus, most companies planning to undertake an IPO will purchase an insurance policy with Side A Coverage, Side B Coverage and Side C Coverage. Some companies going public also decide to purchase at least a small amount of stand-alone Side A coverage in addition to a regular ABC insurance policy because (1) they are being cautious about bankruptcy concerns, (2) they find purchasing a Side A DIC policy is attractive because it is often subject to fewer exclusions than a the Side A portion of a regular D&O policy, and (3) the Side A-only policy can drop-down and respond on a first dollar basis in some circumstances, including if a company wrongfully refuses to indemnify a director or officer. This third reason is particularly attractive because in most cases if a company refuses to indemnify a director or officer for an indemnifiable claim, that director or officer must pay the Side B self-insured retention before the insurance would start to respond. This self-insured retention can be hundreds of thousands or even millions of dollars. As an aside, it is worth mentioning that some very large public companies elect to purchase only

Side A coverage in order to save money on the overall cost of the insurance program by forgoing any balance sheet protection.

Limiting the Insureds Under a Policy. It is possible to limit the insureds under a D&O insurance policy to a subset of all the directors and officers of a company. This is done when there is a desire to limit the number of insureds who are allowed to share the limits of a particular D&O policy. If a company is going to purchase a restricted-insured insurance policy, the insureds are generally limited to all the non-officer, independent directors. This type of policy is typically referred to as an "Independent Director Liability" or "IDL" policy. When the insureds under a policy are restricted to one individual, usually an independent director, the policy is typically referred to as a "Personal Director Liability" or "PDL" policy. PDL policies can also be modified so that they provide insurance coverage for one independent director who sits on the board of multiple companies. Only a very small minority of individuals typically purchase this type of D&O policy.

Policy Definitions. One of the key areas that is in play in a D&O policy are the policy's definitions. For example, whether informal SEC investigations are covered by the policy generally turns on the definition of a "claim," and the answer to this subtle question can mean the difference between being reimbursed for millions of dollars in legal expenses or not.

Another critical definition in a D&O policy is the definition of "loss." In particular, it is important that an IPO company's D&O policy have a "Section 11 Endorsement." Such an endorsement can affirmatively clarify that the insurance carrier intends to include settlements of Section 11 cases in the definition of loss. Without this clarification to the definition of loss, recent case law suggests that a carrier might attempt to take the position that a settlement of a section 11 claim falls outside the ambit of the policy because it does not meet the definition of covered loss under the policy. A sophisticated D&O insurance broker will be able to provide guidance on the types of definition modifications that are available from each insurance carrier.

Policy Exclusions. Like all insurance policies, D&O policies will not pay for a claim if a relevant exclusion removes the claim from the scope of the policy's coverage. As is typical with most components of a D&O insurance policy, the contours of these exclusions are negotiable. For example, one exclusion that will appear on all D&O insurance policies is an exclusion for fraudulent or dishonest conduct. This exclusion exists as a matter of public policy, so no insurance carrier can insure for these items. The critical item that can be negotiated, however, is the point at which such conduct becomes excluded. For example, if the conduct can

only be excluded after a final adjudication of fraudulent or dishonest conduct, then clearly all defense costs will be advanced by an insurance carrier until the final adjudication is made. Most companies and their directors and officers consider this to be a superior result, but a minority may instead prefer that an insurance carrier have the ability to stop spending policy limits on persons the carrier considers to be bad actors so as to preserve the limits for good actors. A skilled broker will identify issues of this type for a company, make a recommendation based on the particular company's risk profile, and then negotiate with the insurance carriers to obtain the desired result. Other typical exclusions found in D&O policies concern areas of exposure for which other types of insurance can be purchased. Examples of these are ERISA claims, many types of employment practices claims, and pollution claims.

Rescindablity and Severability. When a claim hits that has particularly egregious facts, insurance carriers may consider rescinding a policy. This would involve an insurance carrier's taking the position that the insureds misled the insurance carrier at the time the contract between the company and its insurance carrier was formed. As a result, the carrier would assert, it should be allowed to rescind the insurance policy. One way of handling this concern is to negotiate for a non-rescindable policy, at least in part. Side A is the part of the insurance policy that is most easily obtained on a non-rescindable basis. Another way to address the concern that the bad acts of one insured could result in the loss of insurance coverage for innocent parties is to put provisions in the insurance contract that sever bad actors out of a policy, leaving the policy proceeds available for good actors. Referred to as "severability provisions" these provisions can enhance a company's ability to preserve insurance coverage for good actors in the face of unfortunate fact patterns. Obtaining solid rescission and severability provisions is fundamental to the protective strength of a D&O policy.

Claims-Made Policy. One final note on the structure of a D&O insurance policy: D&O insurance policies are typically "claims-made" policies, as opposed to "occurrence" policies. When a policy is a claims-made policy, the policy that responds to a claim is the policy that is in effect at the time the claim is made. By contrast, with occurrence policies the policy that responds to a claim is the policy that was in effect at the time the bad occurrence, the one that is later the subject of a claim, took place. A further complication, however, is that notwithstanding being claims-made policies, D&O insurance policies may have a "past acts" date. When a D&O insurance policy has a past acts date, the policy will not respond to a claim made during the policy period if that claim relates to a wrongful act

(occurrence) that took place before the past acts date. It is critically important to a company's insurance coverage that this past acts date be completely eliminated or negotiated as far back in the past as possible.

Practical Tip: Past Acts Date

A mistake that can be made in obtaining D&O insurance coverage for a company undertaking an IPO is to have a past acts date that is the effective date of the IPO registration statement. While such a past acts date ought to result in a lower premium, the result of such a past acts date would be to exclude from coverage anything relating to the preparation of the IPO prospectus. This is because the prospectus was prepared before the past acts date. Given the vulnerability of IPO companies to litigation related to the prospectus, excluding the process of preparing the prospectus from coverage would be ill-advised.

Selecting the Right Broker

Securing a D&O insurance policy is easy and can even be relatively inexpensive; securing D&O insurance that will actually pay a claim that hits a company and its directors and officers is much more difficult. It is all too easy for a company to purchase a D&O policy that, by its contractual terms, is unlikely to pay for any claims. Counter-intuitively, even purchasing insurance from a reputable carrier is no guarantee that a good policy will be issued to the buyer. The pricing, terms and conditions of an insurance policy are almost entirely driven by the knowledge and skill of the broker placing the insurance contract. For this reason, a company should hire a broker that specializes in this particular type of insurance and places it regularly. Indeed, it is common for companies to have their D&O insurance placed by a specialist and to have a different brokerage place the company's other important but less complex lines of insurance.

A good D&O insurance broker will be able to give a company specific recommendations for limits of liability that are based on historical data and not just peer data benchmarking. The broker should also be able to understand and provide guidance on the important terms and conditions in a D&O insurance policy contract. The broker should be able to help a company address the issues that arise from a company's having foreign subsidiaries, including, in some cases, the need for locally-admitted insurance policies, as well as the need in some cases for changes to be made to

the master D&O insurance program to accommodate non-US legal issues. A company's D&O insurance broker should be able to provide a company with information and advice on alternative vehicles to D&O insurance that can help control cost. It is useful if a company's D&O insurance broker can offer loss control and risk management consulting that can drive down a company's overall D&O insurance premium. The broker should also be able to convey effectively to the insurance marketplace specifics both about the company's risk as well as its insurance requirements. Finally, a D&O insurance broker should be able to supply the company with information about each potential insurance carrier's claims history, financial stability and rescission history. A good place to start for recommendations for D&O insurance brokers is the company's legal counsel.

Practical Tip: Avoid Sending Multiple D&O Insurance Brokers Into the Insurance Market

A company will obtain the best possible terms, conditions and pricing for its D&O insurance if it chooses one broker to speak to all insurance carriers. A less effective strategy that some companies attempt to employ is the strategy of asking multiple D&O insurance brokers to place the D&O insurance on the theory that the company will choose the broker that presents the best program. This is called "dividing the market."

The problem with the multiple broker approach is that insurance carriers will only give quotations for a specific company to a single broker. The greater the number of interested insurance carriers (that is, the more competition for the company's D&O risk), the more a skilled broker can use market competition to lower the premium and improve the terms and conditions of an insurance policy for a company. Dividing the market, on the other hand, has the net effect of limiting the number of insurance carriers that are competing against each other for the same D&O risk. Less competition almost always means a result that is suboptimal compared to the result that could have been obtained if the full insurance market were competing for the same D&O risk.

The Insurance Process

A company will ideally select its D&O insurance broker at least a couple of months prior to the initial filing of the registration statement for the IPO. During the time leading up to the IPO, the broker will work with the company and its counsel to develop an appropriate D&O insurance program for the company. This work includes providing the company with guidance on items of corporate governance about which D&O insurance carrier underwriters are particularly sensitive, such as corporate communications policies and insider trading policies. Also during this time, the D&O insurance broker, in conjunction with the company's management team, should give a company's board of directors a presentation on the company's plans for its D&O insurance. The majority of the insurance work taking place during this time, however, is done behind the scenes by the D&O broker. A company's D&O broker should be working to build a company's insurance program, usually with multiple insurance companies. For example, a company that seeks to obtain $40 million in liability limits might put together its insurance program with as many as four to six different insurance companies.

It is during this time that management and its board of directors should consider the optimal D&O insurance program structure for the company, including alternatives to traditional D&O liability insurance such as Side A DIC policies and independent director policies. It is also during this time that companies should consider the amount of D&O insurance limits they would like to purchase.

Other items that should be considered during this time are concepts such as coinsurance and setting high self-insured retentions. Coinsurance refers to a company's sharing a portion of all losses with the insurance carrier. Self-insured retentions, like deductibles, are dollar thresholds under which an insurance policy would not pay. Having coinsurance and a high self-insured retention are two things that can bring down the cost of D&O insurance. As with most D&O insurance options, however, co-insurance and high retentions pose issues. For example, the premium savings resulting from a high retention may be of little comfort when a claim is made and the company has to go out of pocket for defense costs for a prolonged period, instead of being reimbursed by a carrier for these costs.

Part of the process of building the final the insurance program often involves having members of a company's senior management team speak directly with insurance underwriters. These telephone calls or in-person meetings, which are all conducted under strict non-disclosure agreements,

allow insurance underwriters to get a better feel for management as well as to obtain detailed information that may not be available in the IPO prospectus. These telephone calls and meetings also give management the opportunity to explain to insurance underwriters why the company is a good risk for the insurance carrier.

The entire insurance program should be completed — except for the actual binding of policies – before the CEO and the CFO leave for the investor roadshow. This work includes the completion of any required insurance applications, which can be long and time consuming.

The D&O liability insurance application for a company about to go public often contains a number of representations and warranties that are the basis of the insurance carrier's decision to issue the insurance contract at the agreed-to premium. Misrepresentations or omissions in the application can lead to the rescission of an insurance contract and could therefore, in the worst case, leave all directors and officers without insurance coverage. The application process must thus be taken seriously. Companies often poll members of the senior management team, the entire legal and finance departments, and all the members of the board of directors in advance of completing the application to make sure that the application is as complete and thorough as possible. In addition, between the date on which the application is signed and the date of the IPO, the company has a duty to update its insurance carriers on any changes to the application, such as any new litigation against the company.

The final order to bind a company's D&O insurance program will be placed the night before the company's first trading day. This timing ensures that there is D&O insurance coverage from the moment a company's directors and officers have public company liability exposure, but also that the company is not paying for D&O liability insurance before it is needed. Once the insurance binds, however, the insurance premiums are due and payable. Most insurance contracts allow insurance carriers to cancel the policy for non-payment of premiums after a certain period of time, so it is prudent for a newly public company to pay for its D&O insurance promptly.